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# Debt as power: Public finance and monetary governance in postwar Britain

Sahil Jai Dutta  
PHD in International Relations  
University of Sussex  
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I hereby declare that this thesis has not been and will not be, submitted in whole or in part to another University for the award of any other degree.

Signature:.....

# Summary

It is often thought that a state dependent on debt is in a vulnerable position. But Britain has long been such a 'debt state'. Since the seventeenth century Financial Revolution and the foundation of the Bank of England, the state has amassed levels of debt it could never realistically repay. Far from a burden, the ability to issue its debt as a form of money has been the basis of great power. It provided the state a readily accessible pool of financing and established a monetary infrastructure through which it could govern the broader economy. For that reason, this thesis claims that the British state has never been a passive recipient of creditor agendas when it raised public finance. This provides a different perspective on the development of monetary governance in postwar Britain and in particular the period of transition from Keynesian to neoliberal techniques of governance in the 1970s and 1980s. This is a time often discussed in terms of the British state ceding power to financial markets as it strived for the 'credibility' necessary to support its growing public debt. Instead, this thesis shows how the imposition of monetary targets and neoliberal financial reform were attempts by the state to enhance its capacity to manage liquidity across the British economy. While debt is often assumed to be a problem for the state, this thesis instead shows how debt is a form of state power.

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It is fitting that a thesis about irredeemable debt should start with the acknowledgments. Through the project I have depended on the generosity, expertise and good humour of far too many people to fit properly on here. In keeping with the finest traditions, I hope to pass onto others what I in fact owe to you all.

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# List of abbreviations

£M3: Broad money supply

CCC: Competition and Credit Control

CDs: Certificates of Deposit

DCE: Domestic Credit Expansion

GEMMs: Gilt Edged Market Makers

MLR: Minimum Lending Rate

MTFS: Medium Term Financial Strategy

PSBR: Public Sector Net Borrowing Requirement

QE: Quantitative Easing

# Introduction

Two weeks after the British public voted to leave the European Union, the Bank of England sold £2.25 billion of long-term public debt at a record low yield of 0.91 per cent. Its issue was significantly oversubscribed (Moore, 2016). The broader British economy was still reeling from the outcome of the referendum vote. Sterling had collapsed, the FTSE 250 was down but British public debt remained hot property (Hunter and Toplensky, 2016).

That the government was still able to borrow so cheaply during a time of upheaval, and in a country whose economic fundamentals were so weak<sup>1</sup>, presents something of a puzzle. Common sense would imply that a nation's ability to borrow from credit markets would depend on its future growth prospects, the robustness of its public finances and the stability of its political system. A government that racks up vast debts would surely test the limits of investors' patience. The more debts mount, the more dependent it becomes on creditor support. There must, in that sense, be a limit to the amount of debt a nation can raise.

Yet Britain's historical experience contradicts this common sense. The British state has long been heavily indebted. Since the Financial Revolution in the seventeenth century, which saw the establishment of banknotes and then the Bank of England, the British state has amassed levels of public debt well beyond what it could ever realistically repay. This was not a weakness, but a source of enormous strength. Because through the Financial Revolution, debt issued as banknotes acquired the capacity to serve as money. This transformed the politics of debt because, for as long as debt circulated as money, it did not need to be repaid.

By appropriating the development of banknotes to make public debt circulate as money, the state revolutionised the question of public finance. Simply, if a state could print its own money, what limits did it face? Indeed, the power this provided the British state historically is well recognised. Debt financed Britain's imperial dominance (Brewer, 1990) and debt was foundational to Britain's twentieth century welfare state (Norfield, 2016).

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<sup>1</sup> In aggregate terms Britain had a large public debt, large trade deficit, a significant budget deficit, slow growth, and low productivity (Cadman et al., 2016).

Given this history, it is striking that increasing public debt is now cast as a problem for the state. Many commentators like Wolfgang Streeck (2014a) now depict public debt as a burden on the state that becomes harder and harder to bear as debts mount. This idea is central to the way in which the transition to neoliberalism in Britain is understood. The key moment in that transition to neoliberalism is often thought to be the 1970s crisis of high inflation, high interest rates and slow growth, which was supposedly resolved through the steps Margaret Thatcher's government took to impose 'monetary discipline'. These policies included the establishment of monetary targets, a regressive reordering of the tax regime, and the selling off of public assets to the private sector (Prasad, 2006), which many have argued were the necessary cost of securing 'credibility' in the eyes of international investors (for example Brooke et al., 2005).

Progressive voices counter that securing monetary discipline in this way meant sacrificing part of the state's economic power at the altar of financial markets. The need for governments to be 'credible' in the eyes of their lenders meant the state pursuing only the sort of policies that creditors desired. Streeck (2011, p. 27) encapsulates this view in his suggestion that the state's dependence on external finance allowed 'market justice' to triumph over 'social justice'.

The seeming paradox of the idea that raising vast debts was a source of power for the state in the past, but is now a major vulnerability stems from the way in which the monetary aspect of debt is often neglected in contemporary commentary. This is especially important because the ability of the state to issue its debt as money not only provided a readily accessible source of finance, but it also established an infrastructure through which the broader economy could be governed. For that reason, public debt was a very productive form of empowerment.

The deep connection between money and debt is well known. Indeed even the Bank of England now insists that money is created as a form of debt (McLeay et al., 2014). Yet while many recognise that money is debt, the flip side, of how debt is money, has proved much harder to acknowledge. And by turning away from the moneyiness of debt, many lose sight of the power of the state in monetary governance. Instead, the question of public finance becomes necessarily one about the steps a state must take to attract creditor finance. It is why the idea of 'credibility' is so readily used to explain developments in monetary governance. In contrast to the complexity of monetary relations, the idea of 'credibility' makes the

politics of public finance all about the perspective of creditors. To raise money, a state must simply do what credit markets desire.

As such, these accounts make it appear as if the effort to secure financial market credibility has often come at the expense of the power of the state. Though clear that the state has not retreated under neoliberalism, the seeming juxtaposition of state power with financial market credibility, makes it particularly difficult to account precisely for what role the state played in the construction of neoliberal financial governance. It is why techniques associated with neoliberal financial governance, from monetary targets to later central bank independence, are cast as strategies of 'depoliticisation' (for example Burnham, 2007).

As a result, despite the awareness that the state's power has only grown under neoliberalism, the state is often made to appear as an enforcer, something instrumentalised by creditors for their own desires. The state is designated, as such, a peculiar kind of agency, developing policies like monetary targets in order to curtail the scope of its own actions. As such, writers like Streeck (2011; 2014b) end up in a contorted position where the capacity of the British state to raise vast sums of debt is treated as a sign of its weakness, rather than a source of strength.

In response to such thinking, the central claim of this thesis in response is that the state has never been a passive recipient of creditor agendas when it has raised public debt. As a result, the imposition of monetary targets and financial sector regulatory change through the 1970s and 1980s cannot be thought of as episodes of creditor power. Rather, to recapture the politics of public finance in Britain, it is necessary to keep the moneyiness of debt at the front and centre of the analysis. This means assessing how the monetary aspect of public debt was institutionalised into the British political economy.

Doing so allows for a recasting of the political trajectory of postwar Britain. While the moneyiness of debt first provided a foundation for Keynesian governance by allowing for a great expansion in public debt, by the 1970s it began to pose a problem as private money debt rapidly expanded. The neoliberal reforms to monetary governance that unfolded in response were aimed not at breaking with the past, but at developing the state's capacity to continue monetising its debts through the establishment of neoliberal techniques of financial governance. The fungibility of public debt, the fact it circulates so readily, and was so rarely called in for redemption, meant that the solvency of the state was not a direct problem confronting postwar policymakers in Britain. Consequently, the monetary order that

was constructed in the 1970s and 1980s was never one dictated solely by creditors, but was also driven by the state's need to build the public debt and manage its liquidity.

## Synopsis

The first chapter reviews the literature on public finance and the state in order to establish the research problem underpinning the thesis. My argument centres on the way in which the Financial Revolution, the development of banknotes, and the explosion of debt that followed set British public finance on a unique trajectory; one that demanded a paradigmatic shift in the way the questions of debt, money and the state were conceptualised. The state's ability to monetise its debts<sup>2</sup> meant it constantly confounded the limits its indebtedness was supposed to have established. I show how commentators through history have been unable to fully come to terms with the monetary aspects of the Financial Revolution, and instead have repeatedly been forced to adjust what they understood to be the nature of the debt problem. I bring this historical perspective to bear on the contemporary literature on neoliberal financial governance in Britain. I argue that by sidelining the moneyiness of debt, and the monetary infrastructure that is established through it, existing accounts overlook the interest of the state and its role in the construction of neoliberal financial governance. Instead, posed from the perspective of creditors, financial governance is depicted as driven by the need to impress financial markets. I challenge this by showing how, when recast in light of the moneyiness of public debt, the power of the state in neoliberal monetary governance remains crucial.

The second chapter tracks the development of British public debt to show how and in what ways it acquired monetary features. I show how Britain has been a 'debt state' since the Financial Revolution three hundred years ago. When debt can serve as money, its dynamics are transformed. The question of repayment, and the leverage this provides creditors, begins to fade, and a monetary infrastructure begins to form that allows for a rapid expansion in the level of debt. The development of banknote issuing and the establishment of the Bank of England put the English state in a unique position where it was able to issue its own debt as money. I track the gradual institutionalisation of this development and the way it

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<sup>2</sup> In a broad sense of debts acting as a form of money, rather than the narrow meaning of central bank purchases of government debt securities.

shaped financial governance in Britain. The central position of public debt as a means of payment (money) provided the state with new avenues for economic intervention. This came from the way in which the Bank of England established itself as the sole provider of cash by the middle of the eighteenth century. As the dominant supplier of money, the Bank of England set the terms by which this liquidity was made available to an economy that was becoming ever more integrated through banking networks across the country by the start of the nineteenth century. When public debt was rapidly expanded to finance the two world wars this dynamic was transformed once more. As Keynes argued the fact that public debt was now deeply monetised meant it was now possible, through the management of public debt, to manipulate the commercial activity of the national economy as a whole.

In the third chapter I show how Keynes's insight helped British policymakers finally come to terms with the monetisation of public debt, paving the way for the Keynesian revolution in Britain that was a revolution in monetary governance. By showing the productive potential of public debt Keynes transformed the nature of the problem of public debt. Debt need not be a drag on the economy in the way the classical political economists had insisted. Instead, it was possible for the state to stimulate investment in the private sector. Through his conception of the economy as a nationally integrated system of monetary flows, Keynes showed how a growing public debt would grow the common pool of a nation's economy as a whole. I argue that Keynes's monetary thought has often been lost in the debate over whether Britain ever underwent a 'Keynesian revolution' in economic governance. In making this point I show how the initial postwar effort at Keynesian governance centred on these monetary techniques. For that reason, I argue that the Keynesian revolution was more than a simple departure from 'balanced budgets'. The monetary interventions between 1945 and 1951 that followed Keynes's thinking meant flooding the banking system with such a large volume of public debt securities that the Bank of England's monopoly control on the provision of liquidity was rendered mute. Without a viable monetary policy, the state had to rely on fiscal budgetary governance of the economy instead in the second half of the 1950s and 1960s. The fiscal focus that has come to define Keynesianism is, as such, a post-hoc reflection of the failures of the monetary interventions made in his image.

I explore in the fourth chapter how this paradigm was challenged by the rapid growth of the financial sector. This was because of the way the private banks

developed ways to monetise their debts. Towards the end of the 1960s and the early 1970s, interbank debt became deeply institutionalised as a means of payment within the banking system. This allowed private banks to rapidly expand their lending. It was a dynamic that undermined many of the previously dominant banking institutions in Britain. The clearing banks who were the highstreet names that had dominated British banking since the mid nineteenth century suddenly found their place threatened by new 'secondary banks' who operated in 'parallel' to the traditional clearing bank network. These banks were able to rapidly raise liquidity by issuing short-term liabilities to one another and did not need to draw from the Bank of England or customer deposits in order to make loans. This 'credit revolution' undermined the mechanisms the state had developed to manage liquidity. Simply, through the credit revolution the state's debt became a less important form of money than those of private sector banks. By the early 1970s this necessitated a shift in the way the state managed money. This shift is now often cast as an abdication of the state's responsibility as monetary management moved to a regime of market-led governance instead.

A response to the credit revolution was a series of repeated attempts to rein-in credit creation. Though Keynes had established that there existed no fiscal limit on the potential capacity to raise public debt, critics argued that growing public debt underpinned excessive levels of credit creation and caused inflation as a result. Fixing inflation required policymakers to set targets for the levels of money in the economy. As I argue in the fifth chapter, by the mid 1970s this argument came to be known as 'monetarism' and entailed the public authorities announcing targets for the levels of monetary growth. The move to monetary targeting is now often described as a depoliticisation of monetary governance. Yet when cast in terms of the moneyness of public debt, the evolution of monetary targets in Britain takes on a different light. The discretionary power the state had established through the gradual monetisation of public debt over the previous centuries was not simply dismantled and boxed away. Rather, the mode of control shifted, and the capacity for the state to use monetised public debt for the purpose of economic governance transformed. Whatever the rhetoric, monetarism and the idea of market-regulated credit only ever figured as an aspiration. As I show, by using targets the monetary authorities were hoping to find a way of responding to the credit revolution. I argue the period is best understood as an attempt to build the capacity for interest rate control of the broader economy.



The sixth chapter recasts the neoliberal financial regulatory reform of the 1980s. Often these reforms are depicted as part of the effort to restore 'monetary discipline' to Britain and dampen the political role of the state in monetary matters. Instead, I show how the period is better understood in terms of the way it allowed the British state to increase its debts and improve its capacity to govern the economy through active monetary policy. I argue that by the end of the 1970s the state faced two primary problems with regard to monetary governance. First was the fact that public debt securities had become a less significant form of money than private debt securities since the credit revolution. Second was the fact that the period of monetary targeting had undermined the stable way in which it sold public debt. The financial reforms undertaken in the 1980s helped to resolve these two issues. First, the Monetary Control Act of 1980 reformed the way the Bank Rate was set. Rather than the discount window, rates were set instead through the Bank of England's open market operations in the bill market. This provided greater flexibility for the Bank Rate and helped it adjust more swiftly in line with broader money markets. Next, the Financial Services Act of 1986, better known as the 'Big Bang', opened up the London Stock Exchange, where gilts were sold, to international financial houses which had much larger capitalisations and were able to absorb much bigger gilt issues and sell them to a broader, international customer base. This ended up greatly expanding the size and liquidity of the gilt market, and separated the issue of debt management from monetary policy.

The conclusion discusses how the contemporary place of monetary policy as the primary post-crisis solution, and the ability of the state to issue and purchase vast quantities of its own debt, demand reflection on how public debt securities have become the primary vehicle of global liquidity in the contemporary global political economy.

In sum this thesis makes three contributions. The first is historical: I demonstrate how the British monetary authorities developed the means to grow and service public debt and the way in which public debt securities were used to govern the economy in the four decades after the second world war. Specifically, I show that the 1986 deregulation of the London Stock Exchange help expand the market for British government debt and improve the liquidity of British government debt. The second is conceptual: by holding the moneyiness of public debt in the foreground of my analysis, I overturn the common assumption that debt is constraining by demonstrating how debt has empowered the British state. From this

base I rethink the implications of public debt for our understanding of the transition to neoliberalism. More often than not, neoliberalism appears as a resolution to an over-leveraged state, and driven by the imperatives set by creditors. But when the moneyness of debt is considered, it is possible to see the transition to neoliberalism as a state-led evolution of the monetary infrastructure that had been deeply embedded into the workings of the British political economy. In building the project I make a third, methodological, contribution: I develop an approach able to explore the moneyness of debt. This means examining the process by which debt acquires the capacity to circulate in the economy and serve as money, and also the process by which money empowers the state by providing an infrastructure through which to manipulate the broader economy. Doing so allows for a study of debt comfortable with the idea that in a political economy near defined by its utter abundance, the potential scarcity of debt is not a secure enough anchor on which to conduct an inquiry. Ultimately, I build the tools for considering the way in which public debt can be a basis of state power.

# 1. The paradox of the neoliberal debt state

## Introduction

The state of the public finances is central to the way neoliberal governments present their reforms. In recent years, British politics has been near defined by the Conservative government's insistence about the 'need to pay down the debt' (for example Osborne in Chan, 2015). This, though, did not stop them from undertaking policies that in fact led to an increase in both the budget deficit and the national debt (Treanor and Allen, 2016). The fact that, more often than not, periods of so-called neoliberal retrenchment coincide with an increase in debt - both public (Simon Rogers, 2013) and private (Montgomerie, 2015) - prompts many to suggest their claims are cover for something else, with critical voices dismissing anxiety over public finances as an 'ideological front' for regressive regimes (for example Krugman, 2015). Recently, however, there has been growing academic attention on the question of the politics of public debt, with critical literature (for example Streeck, 2014; Hager, 2016; Bear, 2015) arguing that a state's dependence on debt raised from private sector financial markets is a key feature of neoliberal politics.

The recognition that debts have only grown under austerity throws up an apparent contradiction: neoliberal governments cut public spending to increase their capacity to borrow more. If governments are being forced by credit markets to restructure their political economies with public sector cuts, then why don't those same creditors mind when spending does not fall, as was the case during Margaret Thatcher's government of the 1980s (Eaton, 2013) and the Conservative regime of today (Katie Allen, 2015)?

In that sense it is not simply the aggregate level of public debt that matters. Rather how public debt is being used is significant too. The literature on debt has recognised this but pushes the idea that debt-dependence suits a particular political agenda, those of creditors. To make this claim there is often a unspecific notion of who these creditors are and what their interest might be but neoliberal reform is presented as establishing the political conditions for borrowing to continue securely (Streeck, 2014a; Blyth, 2013; Lazzarato, 2012). This has been taken to mean

reorganising government action in the economy to broadly favour the interests of creditors (Streeck, 2014) by cutting areas of spending that credit markets deem unimportant and developing rules that limit the government's policymaking options (Burnham, 2011). By this reasoning, when governments simultaneously cut both welfare spending and taxes at the top of the wealth bracket (where creditors tend to reside (Hager, 2016)), they demonstrate to credit markets their 'commitment' to the kind of programmes that will see them reducing their future borrowing requirements. This argument explains why fiscal 'credibility' can be such a ubiquitous idea in understanding the actions of neoliberal governments (for example Clift and Tomlinson, 2008; Gill, 1998; Hay, 2004). George Osborne, for instance, often explained how, despite slow growth, repeated deficits and mounting debt, his macroeconomic reforms helped ensure Britain remained a credible "safe haven" in the eyes of creditors (BBC News, 2011).

Used this way the idea of credibility is the solution to the paradox of the debt state and is the implicit notion that connects debt to neoliberalism in the literature. When mobilised in this way the necessity to remain 'credible' in the eyes of credit markets always appears as a limit on the state. Governments cannot do anything they want and cannot borrow indefinitely because they must remain 'credible' in the eyes of wealthy, private sector creditors (Hager, 2016). Credit markets come to be cast as the ultimate sovereign, checking the arbitrary power of governments. Or, as James Carville, Bill Clinton's campaign manager, put it in one of the pithier articulations of the frustrations of the debt state: "I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody" (in Mcardle, 2011).

In this respect, the transformation of economic policymaking in Britain through the 1970s and 1980s has often been seen as an iconic case study of neoliberal transformation (Harvey, 2007; Peck and Tickell, 2007; Fourcade- Gourinchas and Babb, 2002). In the eyes of many writers (for example Kerr, 2001; Green, 2013; Seymour, 2016) the purpose of the last years of the Callaghan government, and then especially the Thatcher regime, was to restore Britain's credibility in the eyes of international credit markets. This happened through an assault on (some forms of) public spending, public industries, and workers' wages. Champions of the neoliberal transformation (for example Minford, 2015; Brittan, 1988; Crafts, 2012) see this period as a necessary disciplining of the

country's economy by the forces of the market. Critics see the economic folly and social upheaval that followed and bemoan how market rule muscled over a more democratic order (Streeck, 2014; Blyth, 2013). But when examined against the history of the British state, the notion that the need to ensure credibility in the eyes of creditors checks the discretionary power of the state and its fiscal outgoings runs up against significant factual problems. The historical work of John Brewer (1990) and Samuel Knafo (2013) have shown that the longer history of the British state and central banking is defined by its ability to empower itself through borrowing. It was its vast national debt that built its colonial capacity (Brewer 1990), its success in the first world war (Braudel, 1982), and the construction of the postwar welfare state (Norfield, 2016).

Crucially, this capacity came from the way public debt has been used as a form of money in Britain. Ever since the seventeenth century Financial Revolution the ability of the state to monetise its debts has granted it enormous flexibility in the scope of raising debt finance and opened up avenues to use public debt securities not just for raising spendable funds, but as a much broader basis for widespread economic governance. This monetary aspect of public debt has political dynamics that are hard to pin down. But it helps to recontextualise more recent developments in monetary governance. For example, the monetary aspects of public finance helps one to understand how, during Thatcher's time of painful 'monetary discipline', the state found a way to vastly expand the size of the market for its public debt (Bank of England, 1989), even when that meant overcoming the resistance of the financial houses that had brokered the sale of public debt for years (Moran, 1990). Similarly, in the aftermath of the 2008 financial crisis, ostensibly neoliberal governments harnessed the monetary aspects of public debt when central banks bought back their own public debt issues through the so-called 'quantitative easing' ('QE') programme. Indeed, the Bank of England handed the £34.7 billion in interest payments it received on gilt repurchases back to the Treasury, reducing the overall size of the government's budget deficit (Bank of England, 2016). The QE process actually resembled the monetary policy of the second world war and the period that followed (Allen, 2014). Back then such 'cheap money' was considered archetypical of a Keynesian interventionist state. Now QE is deemed neoliberal (for example Green and Lavery, 2015). Yet the fact that the British indebted state has the capacity to undertake such policies challenges the notion that its dependence on debt narrowed its room for manoeuvre and led to a

political economy scripted by, and for, a creditor class. In that sense, the monetary aspect of British public debt has constantly provided a basis for the state to empower itself through its operations in public finance.

In this chapter I establish how the moneyness of public debt provides a foundation to reconsider the transition to neoliberal financial governance in Britain. The chapter is divided into three sections.

The first outlines how the conception of public debt has evolved over time. I focus on how the Financial Revolution, which provided the English state a unique capacity to finance itself through issuing banknotes, transformed the analysis of debt that had previously prevailed. Given the significance of the revolution it is no coincidence that classical political economists emerged in Britain challenging previous ideas about debt and establishing foundational assumptions about the state's limited ability to build up debts indefinitely, and how as a result, increasing public debt will eventually produce a public crisis. The classical assumptions, however, were confounded by the gradual institutionalisation of public debt into the broader economy, which saw public debt acquire monetary features. The more the state was able to monetise its debt, the more distant the 'limit' became and the more management of the public debt could be used for centralised governance of the economy as a whole. In that way public borrowing helped build the capacity for interventions by state officials and thereby a degree of autonomy from credit market actors. As such the state as a borrower found ways to 'buy time' and 'tame' its indebtedness. Despite this, the monetary features of public debt have yet to impact upon the way debt is conceptualised in the literature.

As a result, as I show in the second section, when debt is mobilised as part of the explanation of the shift to neoliberal governance in contemporary literature, public policy is cast in terms of the need for governments to be credible in the eyes of investors, which gives the sense of neoliberal policy as something designed for the appeasement of creditors. As a result, it becomes very difficult to conceptualise the discretionary power of states in constructing the neoliberal order. If, however, the monetary dynamics of public debt are considered, ceaselessly growing debt becomes more understandable, granting space for rethinking the primary problems driving neoliberal financial reforms in Britain.

The third section then examines what it means to analyse the transition to neoliberalism in Britain when we keep the moneyness of public debt at the centre of the analysis. It argues that we cannot grasp the debt politics of the transition to

neoliberalism from the perspective of abstract creditors and whatever we assume to be their interests. Rather we should examine how the state's effort to raise debt helps to forge a particular kind of state power that can later be mobilised for the purpose of policymaking. This is what happened through the development of central bank money (Knafo, 2013) and the Keynesian apparatus after the second world war (Tily, 2010). This will allow to me to argue later in the thesis that this took place again during Thatcher's time through the way the 'Big Bang' helped to greatly expand the market for public debt.

### 1.1 The classical roots of the dangers of debt

The Financial Revolution in England transformed the state of English public finance and the way debt was understood. It provided the English state a unique capacity to finance itself on the basis of banknotes, greatly increasing the size of its debt and the scope of debt financing. Soon after the revolution, the scale of the public debt jumped well past the level at which full repayment could ever realistically be expected (Dome, 2004; Brewer, 1990).

Up until then, discussion about debt was articulated not in the quasi-scientific language of political economy but in more explicitly moral concerns over usury and money lending and was, as such, something regulated by appeals to religious, ethical and moral systems (Dodd, 2014). The problem of usurious debt was that it was an unfair exchange, violating principles of reciprocity that had underlined commercial-like exchange (Graeber, 2013). There were, as such, deep suspicions about usurers, and the wealth they acquired "without the production or physical transformation of tangible goods" (Le Goff, 1990, p. 18). Rather than facilitate productive investment, the usurer leant for consumption and often to desperate people. Usurers lacked any particular social clout and were kept on the margins of commercial activity with their kind of interest-based lending officially restricted in England, and banned by Parliament in 1552 on the basis that it was a practice that opposed the word of God (Knafo, 2013).

These kinds of restrictions on financiers inhibited the development of banking in Britain, something that became a problem for both landlords (who wanted to develop agricultural industry) and, more pressingly, for the state. It lacked a developed financial market to draw from and relied instead on forced loans from the English aristocracy, financial support from abroad and manipulation and

debasement of currency on a vast scale (Knafo, 2013, p. 77). In that way there were clear limits to the state's ability to finance itself through borrowing.

The seventeenth century Financial Revolution and the foundation of the Bank of England in 1694 changed all that. Through banknote issuing the state was always able to increase its debts, without having to debase its stock of coins. The Financial Revolution is often discussed as part of the broader Glorious Revolution that supposedly established the early liberal state in England. The state's success borrowing vast sums of money was, by this account, a consequence of the 'credibility' the state had acquired in the eyes of investors who were convinced that the state's emerging liberal character would ensure their loan agreements would not be violated (Brewer, 1990). Again here is the contradictory notion of the state empowered financially through its political disempowerment.

If, however, the Financial Revolution is cast as a revolutionary innovation in money, rather than politics, the implications for public finance look different. Debts grew not because lenders had 'confidence' in the state, but because of the technique developed by the London Goldsmiths to issue discounted banknotes as credit. I discuss the discounting revolution in greater depth in the following chapter but for now it is worth stressing that when the state appropriated the technique of debt discounting through the establishment of the Bank of England, it effectively discovered a way to rapidly monetise its debts. Institutions soon developed around this monetised debt that helped ramp up the levels of public debt.

As a result of both monetised state debt, and the increasingly 'productive' role money lending was playing in the development of agriculture after the early enclosures (Wood, 1981), it made less sense to discuss moneylending in the terms of usury. To focus on debt as an unequal exchange between two private parties seemed less relevant. The emerging public debt was less bound up with interpersonal connections or any in particular trade as had been the case previously (Dodd, 2014). Moreover the way public debt circulated meant it appeared abstracted from any particular social bonds and seemed to belong to the economy as a whole (Graeber, 2013). And it was on these grounds that classical political economy altered the tenor of the debate on debt. The normative belief that large debts were unwelcome did not shift and David Hume was wary of the potentially usurious motives that underpinned paper money (Sgambati, 2013, p. 122). Yet he, and the classical political economists that followed, had to recalibrate the problem away from a focus on unequal exchange among individual parties, and



onto the more formal worry about the long-term effects public debt had on the economy as a whole. Yet the Financial Revolution made this problem incredibly difficult to pin down. The longer the state went on successfully ramping up levels of public debt, the more difficult it was to clarify where exactly the limit to the process lay. The moneyiness of public debt made its dynamics slippery. As such from Hume to Smith to Ricardo you see repeated efforts to try and adjust the experience of ever-rising public debt to the assumption that such developments must surely be unsustainable.

It was with classical political economy that the monetary aspects of public debt became sidelined in favour of a reading of debt based upon its unsustainability. Hume, for example, had witnessed the English crown finance repeated wars through the expansion of paper-issued public debt, something that had come on the back of a recent history in which the state had actively manipulated its currency to feed its deficit expenditure. He focussed, as a result, on restricting the growing power of the “moneyed interest” which he felt was acquiring undue political prowess. He saw the growth of public debt as stemming from this power and allowing “moneyed interests” to “sink into the lethargy of a stupid and pampered luxury” (Hume 1987 [1752]: 357–8, in Dome 2004, p.1), paid for at the expense of taxpayers (landlords in particular).

Hume’s broader critique of mercantilism also implied a different treatment of money. While mercantilists chased surpluses of precious metal, seen as valuable ends in themselves, Hume argued that such a pursuit was fruitless because a state would struggle to sustain the balance of payment surpluses necessary to accumulate bullion in the mercantilist way. Rather, international market forces would correct the imbalance. Better a country concentrates on growing its productive capacity – its real wealth – than acquire stocks of money which could only nominally signify wealth. As Sgambati (2013, p. 122-3) puts it:

“[F]or Hume what is really at work in the creation of value by a nation – in the valorisation of its stock – is not the accumulation of bullion per se, because here more money would simply imply (*ceteris paribus*) higher prices, but a universal mechanism underpinning its harmonious association with other nations: the price-specie-flow mechanism.”

The price-specie-flow mechanism became the basis of classical reasoning on the market management of money. But it always represented more of an aspiration to be strived towards, rather than a reality on the ground. Paper money threatened the

idealised working of the mechanism because it could be issued without limits. The bind Hume was trying to untangle was how to square the monetary dimensions of paper debt, with the underlying fiscal order. There appeared a 'monetary' versus 'real' split in the workings of the economy once the paper promises of public debt issued as notes had been established.

As such, through his price-specie-flow mechanism Hume helped to establish the problem of money as a problem of inflation. If paper money was issued to a level that went out of step with the economy's needs, then inflation will follow. Hume's suspicion was that financiers would partner with the state to over issue banknotes. As a result he advocated for a limit on money creation through the use of hard currency, coins with intrinsic value that could not be "multiplied without end" and "sink to nothing" in the way paper money could (Schabas and Wennerlind, 2007, p. 109). That would ensure the laws of his mechanism would be obeyed.

Apparent already in Hume's sketching out of the price-specie-flow mechanism, and his attendant belief in hard currency, is a transformed sense of the problem of money and debt. The morally-charged themes of 'just-price' and usurious, unequal exchange were giving way to what Sgambati (2013, p. 124) describes as "a growingly technical debate on monetary theory and policy" about matching the correct level of banknotes to the underlying transactions in the real economy. The problem was less that vast loans would impose an unequal relationship between lender and borrower, and more that growing paper debt issues would lead to inflation, and thus needed to be anchored by a hard currency.

In that sense the foundational classical political economy laid out by Hume did not really come to terms with the implications of the moneyiness of debt. Hume's fear was that while in the short-term it may be possible to print more debt as money, eventually the rules of the price-specie-flow mechanism will kick in, inflation will arrive and the economy will suffer. As such Hume focussed on how a liberal state could generate sufficient revenue to repay its debts, and avoid an inflationary solution to excessive debts (Dome, 2004). Hume never resolved the problem he sketched out, and instead could only foresee a "natural death of public credit", through voluntary default, or a deliberate inflating away of the debt by government (ibid., p.204), either of which would destroy the basis of further public credit.

What is clear from Hume is the scale of the challenge of the Financial Revolution. Put simply, how was it possible to conceive of limits on the economic capacity of the state when it suddenly seemed able to ceaselessly create its own

means of payment? The strategy he introduced in response was to search for a fiscal bottom line, which would ultimately work to contain how much money could be borrowed. Hume, as such, argued that the limit to public borrowing arose because it was an unproductive loan that crowded out productive investment. A continual build up of public debt would necessitate continued increases in taxation on landlords, draining away money that would otherwise have been put to productive use. In that way debt and the tax that followed etched away at the productive capacity of a nation until it eventually collapsed. The suddenly boundless potential of paper money production, in Hume's thinking, was a problem that could be contained through a hard currency anchor.

The broad framework laid out by Hume, that turned debt and money into a more technical than moral problem, and centred around the correspondence of note issues to the underlying economy, was taken up by Adam Smith in a slightly different way. Smith did not share Hume's view on the necessity of hard currency, instead proposing a 'real bills' doctrine that argued banknote issuing need not be inflationary. Notes issued against bills of exchange, he suggested, could be thought of as advanced payment. Broadly, provided banks did not over-issue, the supply of banknotes would follow variations in the number of exchanges taking place. Or, the nominal money-economy, would follow the underlying real economy. The key then, was to allow money to form out of private sector demand. Where a problem arose was when money issuance grew out of step from the underlying real economy. In public debt, as a result, inflationary danger lurked. And on this basis he returned to similar grounds as Hume. The bottom line was the underlying real economy, to which public debt, and the notes that financed it, had to correspond.

Smith fleshed this out through his well-known concerns about public spending and taxation draining the productive resources of merchants, who could grow the wealth of the nation as a whole. It is possible to see in this the solidifying of the notion of public debt as drawn from a 'common pool' of resources produced by the private market economy. If debts continued to grow, eventually states would be left with no choice but to tax merchants ever more (so as to honour their debts) which would squeeze merchants out of the productive economy, robbing states of their ability to generate any revenue to restore the common pool of resources. The public debt and money that circulated because of it would have grown too distant from the underlying real economy, and would only lead to crisis. This could be in the form of an explicit government default or, by Smith's reckoning, a more sordid

inflationary route, a “pretended payment” through “an adulteration of the coinage [that] was an unjust and treacherous fraud” (Smith 1976 [1776]: 930, in Dome 2004, p.57). Smith’s solution was to both reform the tax system (though Smith recognised this would only hit landlord rents) and more importantly to withdraw military support from the colonies. Without such fiscal consolidation - to use the contemporary parlance - governments would be left with “enormous debts which at present oppress, and will in the long-run probably ruin, all the great states of Europe” (Smith in Blyth 2013, p.113).

Yet, that bottom line, that moment of crisis, kept getting further away. Smith had already noted how “Great Britain seems to support with ease, a burden which, half a century ago, nobody believed her capable of supporting”. But he was sure time was running out: “Let us not, however, upon this account rashly conclude that she is capable of supporting any burden; nor even be too confident that she could support, without great distress, a burden a little greater than what has already been laid upon her” (Smith 1776/1976, V.III p. 929 in Theocarakis 2014, p.10). It spoke to the difficulty paper money presented the classical political economists.

The public debt, meanwhile, only continued to expand. By the early nineteenth century, paper money had superseded metal coins as the dominant means of payment in England and Wales (Davies, 2002, p. 278) and the question remained of how to conceptualise that underlying bottom line, the centre of gravity into which the monetary stock had surely to collapse eventually. By this point David Ricardo had departed from Smith’s idealised view about the supply of money following market demand to centre much more clearly on the Bank of England. Writing after the suspension of the Gold Standard in England had provoked much debate and derision, Ricardo was deeply suspicious of the Bank of England which he felt was creating bank notes unduly. He critiqued the applicability of the real bills doctrine to Britain and instead pushed a Bullionist position in parliament that would turn modern money back into the hard currency that Hume had advocated. Ricardo pushed for the Gold Standard to limit the distorted money creation by the Bank of England, and as a rival stockbroker himself, took great umbrage at the Bank’s monopolistic position which he felt extracted undue profits from the public. To Ricardo, it was “lamentable to view a great and opulent body like the Bank of England, exhibiting a wish to augment their hoards by undue gains wrested from the hands of an overburdened people” (Ricardo 1951–73 [1816], vol. 4: 93 in Dome

2004, p. 132). Ideally money creation would be handled by the state but, through the use of hard money, would only follow market activity.

These views of money creation were undergirded by a general liberal suspicion about the ill-effects of public debt. Though Ricardo was vehemently anti-tax, and anti-government spending, he did actually advocate for a lump-sum tax on property to fix the national debt (Dome, 2004). He did not want the Bank of England continually absorbing interest payment money and saw in the national debt a diversion of savings from useful to useless investment. Indeed, it is not true, as has been later inferred by conservative writers like Robert Barro (1974) and James Buchanan (1976), that Ricardo saw public debt as equivalent to tax, rather Ricardo saw public debt as worse (Dome, 2004). While taxes eroded future investment and therefore future productive potential, public debt diverted existing investment and therefore the current productive potential of an economy (Tsoulfidis, 2007). It is precisely why in Parliament in 1819, Ricardo advocated for a capital levy and abolishing the Sinking Fund that was supposed to, but hadn't, provide a pool to repay the national debt. The continual build up of debt, thought Ricardo, would injure the wealth-generating capacity of a country and inevitably lead to crisis.

The classical work on public debt is revealing. Firstly, by negating the implications of the moneyiness of debt, their examination of public finance is anchored by the notion that debt must be repaid, and is therefore unsustainable. The fear is always that refinancing a continual build-up of debt can only go on for so long before it hits a limit and the state faces a moment of collapse.

Secondly, as a result, their attention is on how the state can generate the revenue needed to repay debts, making debt politics an issue about the distribution of taxation and public spending. Inevitably this introduces another normative layer. Hume felt landlords should be protected from taxation, while Smith wanted to ring fence merchant activities from taxation and Ricardo overcame his aversion to tax to advocate for a capital levy, as well as restrictions on the Bank of England's ability to create state debt as money. Needless to say each of these positions chimed with their own interests.

Thirdly, and perhaps most importantly, in order to establish a sense of a 'bottom line' to the levels of debt that can be issued there is an assumption in the classical literature that governments draw from a 'common pool' of finite resources when they raise debt, and the more it draws down by mounting debt, the less resources there are for anyone else. On this basis debt growth can only be

'excessive' and a distortion of some underlying fundamental, that will make itself felt in the form of a 'solvency limit' forcing the crisis and correction that drags public finances back into balance.

That the problem of 'excess' and 'unsustainability' should be so present in the classical literature is perhaps unsurprising. Hume was responding to the Financial Revolution that had first allowed public debt to climb to levels where repayment seemed impossible, Smith wrote at a time when the costs of war in America had bled the public exchequer and feared the English state would go the same way as the Dutch and French into bankruptcy, and Ricardo was actively campaigning in Parliament after the suspension of the Gold Standard after the state had run successive deficits. Nonetheless the classical work provided a basis that saw the growth of public debt as a crisis for the state that had to be avoided.

## 1.2 Governing dangerous debt

This notion endured until John Maynard Keynes helped transform the question of debt. Having recognised that the moneyiness of public debt allowed for its great expansion there was a shift in the paradigm of public finance in the early twentieth century. Debt was to become a tool to embrace, rather than a poison to avoid, opening up the question of financial governance and the state's role in it for the first time.

That it took until Keynes to reframe how debt was understood stems from how soon classical political economy emerged after the Financial Revolution and the difficulty it had in fully coming to terms with what had been unleashed. In financing public debt through banknote issuing the problem of state action in a mercantile economy - the securing of gold and silver - was transformed. It was suddenly possible to create a debt-based means of payment 'out of nothing'. What that meant for economic governance was unclear to classical political economists, though it certainly transformed how the repayment imperative was felt.

This was because, as Keynes came to recognise, as paper (debt) money became accepted as a means of payment, the actual moment of redemption became more and more delayed (Sgambati, 2016). As Hume himself recognised "public securities [have] become a kind of money, and pass as readily at the current price as gold or silver - no merchant now thinks it necessary to keep by him any considerable cash" (in Brantlinger, 1996, p. 92). For precisely this reason it was possible to greatly expand debt. Publicly-issued banknotes showed how debts

could be extended, refinanced, and resold for ever growing periods without needing to be repaid, deferring the 'solvency limit' seemingly indefinitely. As such the question about public debt was not solely about public spending and tax revenue, but was becoming more deeply about its role in the workings of an emerging 'national economy'. In that sense, the moneyiness of public debt possessed was in the process of establishing a monetary infrastructure through which the state gained the capacity to govern the broader economy.

These developments provoked a rich vein of monetary thought in Britain that was to culminate in Keynes's paradigm shift. In this the monetary control debate that emerged in middle of the nineteenth century (O'Brien, 1997), as the Bank of England sealed its grip as the monopoly supplier of banknotes in the country (an issue examined in more depth in the following chapter), was very important. Having seen the state greatly expand its debts, and state paper money become central to the operation of the payments system in the nineteenth century, monetary thinkers began to confront the situation where the repayment imperative and unsustainability of debt existed in a very different institutional context to that with which the classical political economists had first grappled.

In this way the fiscal perimeter to the state's capacity to borrow seemed less of a pressing problem than the potential for ceaselessly created debt to court inflation. Nineteenth century monetary thinking began to shift accordingly, adjusting the classical concerns about debt to the new institutional environment by focussing on the instability stemming from the ease of credit creation. It is in this context that the establishment of the Gold Standard should be understood. The Gold Standard came out of an attempt by English landed interests to control the ability of moneyed interests to easily create credit, which they felt courted the inflation that eroded the value of their (fixed) rental income. As Knafo (2013) argues this led to the transformation of the Bank of England into a modern 'central bank' whose central position in the national payments system gave it the capacity to steer credit creation (this is discussed in more depth in the following chapter). By the end of the nineteenth century, with the emergence of a central bank and a European Gold Standard, monetary thinkers like Walter Bagehot examined the position of public debt securities in the broader economy and the necessity for government, acting through the central bank, to govern the monetary system that would otherwise produce instability (Mehrling, 2010). Recognition, in other words, that the moneyiness of the state's debt meant it was now deeply embroiled within the

workings of the financial system and the state bared the capacity, and indeed responsibility, for its governance.

Yet when it came to understanding what governance role the state should play, and how the capacity of the state as a debtor to shape broader economic relations was built on the institutionalisation of the monetary aspect of public debt, monetary thought until Keynes was still bound by the terms of the classical political economists. Ralph Hawtrey was a very important case in point. Hawtrey can be seen as the successor to Bagehot and central to the development of economic thought at the British Treasury in the early twentieth century (Mattei, 2016). He drew from Ricardo especially to argue that the growth of public debt would lead to inflation. Hawtrey had recognised that state money had become so deeply institutionalised within the banking system and so readily treated as a store of value in itself, that its redemption - and the solvency of the state as a result - was a less pressing concern (Mehrling, 2010). This made it very easy for the state to facilitate rapid credit creation. Yet, anchored in the idea that debt creation was unsustainable, Hawtrey was convinced this would inevitably lead to inflation (ibid.).

His arguments about the 'instability' of credit creation became especially important in Britain after the first world war, when the country was saddled with high debts. To guard against inflation he argued that credit creation had to be controlled, advocating for 'dear money' through the restoration of the Gold Standard and a clamp down on public spending (Hawtrey, 1919). This would ensure that credit creation did not become 'excessive' in a way that would threaten the 'credibility' of government as a debtor.

It is here where Keynes was so influential. He reversed Hawtrey's reading of public debt. By acknowledging the capacity the state had acquired through the position of public debt securities in the banking system and the importance of the central bank, he advocated an entirely different approach to public debt. It was an opportunity to grasp. This was essentially Keynes's challenge to the Treasury View that Hawtrey had developed in the 1920s. Investment, he argued, was inhibited by uncertain expectations about the future and as such there was a role for government to 'fill in the gap' by spending money that the private sector was reluctant to part with (Tily, 2010). In that way it could mobilise debt to help build productive capacity and in that sense prevent any chance of a solvency 'limit'. As early Keynesian economists Alvin Hansen (1941) and Abba Lerner (1961) argued, there was as such no potential limit to the 'common pool' and the capacity for public



debt financing if debt was raised domestically and used for productive purposes. The solution to the public finance predicament was for the state to facilitate investment. And debt provided the means through two possible routes. Either it could be raised for direct government investment, or national debts could be used to keep interest rates low enough to stimulate private sector investment (Tily, 2012). Either way, recognition of the possibilities of debt in this way made Keynes highly critical of the orthodoxy that surrounded him.

Yet Keynes did not depart entirely from the classical thinking on debt. His argument rested on the idea that public debt had to be used for productive purposes if it was to pay for itself. Though Keynes showed how debt could grow the common pool, he retained a notion of the common pool, a real economy to which monetary developments were bound. If debt did not fund productive investment, and debts surpassed a certain level - when they became 'excessive' - creditors would lose faith, and inflation would ensue until a crisis forced the moment of correction, undoing all that had gone before. As such while Keynes was significant in showing how state spending was not, by definition, parasitical to the economy and thus debt did not necessarily breed political economic ruin in the way Hume and Smith laid out, the state's ability to raise debt still depended on the capacity of the economy to deliver growth. Increasing proportions of national debt, in relation to the total size of the economy, risked paper money losing its value. As an instrument of government borrowing, money needed to be credible and that meant the assurance that the broader national economy was growing.

The result of Keynes's work was to politicise the state as an economic actor in a different way to before. To be 'credible' in the eyes of creditors and be able to secure the debt with which to finance productive investment, the state had to be judged as an economic agent. By the 1960s, for example, the Plowden committee which had been commissioned by the Treasury to examine the place of public spending noted how "[The] Budget is seen not as a simple balancing of tax receipts against expenditure, but as a sophisticated process in which the instruments of taxation and expenditure are used to influence the course of the economy" (1961, p. 6).

The idea of the productive capacity of an economy being important to the credibility of the state's debt, and the efficacy of the state as an economic agent, proved crucial in shaping the way creditors and debtors related, because it helped found more systematic analyses of public debt (Tribe, 2015). Macroeconomic

indicators (which of course Keynes was crucial in establishing (Tily, 2009)), like the total debt to GDP ratio, or productivity, or balance of payments deficits, could be used as a basis for politicising the public debt. It is here that public debt began to collapse into a series of broader political economic issues and is part of the reason why 'supply side' strategies - like attacks on trade unions or regulatory reform - came to be associated with public spending cuts in the literature on the transition to neoliberalism (for example Blyth, 2013; Kerr 2011). Yet it also revealed how loose the notion of 'excessive debt' could be. There was no fixed 'ratio' for the point at which public debt becomes a problem, nor an established framework to judge whether public debt was successfully building productive capacity or not. Put simply there were times when debt-financed expansion coincided with growth, and other times when it did not.

Moreover, in the postwar era when sterling was tied not directly to gold but to the dollar the problem of 'excessive debt' was felt slightly differently again. There was a growing debate about the way public debt intermeshed with the monetary system and the fixed exchange rate regime of Bretton Woods. In order to maintain exchange rate parity Britain needed access to dollars. It could do this either by increasing exports or buying dollars from the open market. The latter proved much easier than the former but absorbed Britain's foreign exchange reserves. The more reserves were depleted the more difficult it would supposedly become to raise government debt, because creditors were not convinced that the state would be able to maintain the value of the currency over the long-term period on which gilts were issued (Allen, 2014). As such government borrowing also had to take place directly through the banking system, which increased the supply of money and (it was assumed) consumption on imports, which in turn worsened the balance of payments problem (Kerr, 2001). This again made it possible for the clutch of related problems in the British political economy to coalesce around the notion of public debt.

It is in reaction to this context that the 'Chicago School' theorists like Milton Friedman or James Buchanan should be read. The shift that had taken place through Keynes was to accept how there appeared to be no fiscal bottom line to the state's capacity to raise debt. The monetarist response was to shift the bottom line from fiscal to monetary grounds, and in that sense reflected an acceptance of the moneyiness of public debt. Simply, public debt was cast as the source of money creation and the source of inflation. This neoliberal articulation of the problem of

public debt became the template by which subsequent literature on the transition to neoliberalism in Britain has been conceptualised (for example Blyth, 2013). To take Buchanan first, he updated the liberal suspicion of state officials present in Adam Smith through his development of public choice theory. The significance of this for conceptualising the public debt was in formalising the idea that public officials in the state would be unable to act as coherent and productive economic agents because they are self-serving utility maximisers who will divert state resources to the interest groups that best serve public officials (be this a particular tranche of voters or a dominant lobbying group) (Buchanan, 1975). Democracy, whether enacted via votes or voice, was something that had to be resisted or controlled, lest state officials waste resources placating its needs. Buchanan, with Richard Wagner, converted his theoretical commitments into political tract with the publication of *Democracy in Deficit: The Legacy of Lord Keynes* in 1977 and it spoke well to a period where growth rates in developed countries were comparatively low and the efficacy of supposedly state-led Keynesianism highly doubtful. This was to have important consequences for how critics of neoliberalism depicted the move as ‘anti democratic’ (for example Bruff, 2014; Gane, 2015; Flinders and Wood, 2016), in effect adopting Buchanan’s framing while reversing the normative commitments.

Buchanan, though, remained a more significant figure in the United States than he did in Britain. Friedman, on the other hand, found much more purchase among British policymakers with his arguments about monetarism. I revisit the monetarist critique in more detail in chapter five, but for now it is worth noting how the monetarist case revived Hume’s notion of the price-specie-flow mechanism and Hawtrey’s ambition of trying to make paper money behave more like commodity money so that a ‘market’ based monetary system would regulate economic activity, and solve distortions that government debt-financed programmes had caused (Chick, 1993). At the time a flurry of new credit instruments had eroded the government’s existing capacity to regulate credit in Britain, so the promise of monetarism was bright. The idea was that if regulators could control the creation of credit, which in the way it was calculated in Britain’s financial system meant limiting government borrowing, then paper money would obey the conventions of the quantity theory of money and distribution of credit would follow a market logic. Anything else, said Friedman, would lead to temporary stimulus and eventual inflation (ibid.). The result would be creditors doubting the credibility of government borrowers and increasing the cost of borrowing until a drastic resolution is found.

Despite acknowledgment that monetised state debts are stubbornly liquid and, in the case of central banking, that public debt provided the state a capacity for policy interventions that did not previously exist, it was still the prevailing view that public debts were unsustainable and excessive debts left the continued viability of a government at the whims of creditors. Eventually, so the story implied, the limitations described by the liberal classical political economists kick in and debts become unbearable and reforms must take place that restore a government's credibility in the eyes of creditors in the market. It is precisely why it is argued that the transition to neoliberalism in Britain began with the imposition of monetary targeting by the IMF from whom Britain needed to borrow in order to restore its foreign exchange reserves (Clift and Tomlinson, 2008; Clift and Tomlinson, 2012). From that nadir reforms began to take place which were then rapidly expanded by Margaret Thatcher's 1979 regime. The stories of the supply-side revolution, the attack on Labour unions, the high-interest-rate deflation of Britain's manufacturing sector, all of this appears as the necessary correction to the problems built up in the previous years, steps the state had to take to make itself 'credible' again.

### 1.3 Debt and the neoliberal transformation

The fact that debt has acquired more and more monetary functions presents a problem for the analysis of debt. It becomes very difficult to rediscover a bottom line, the limit that is supposed to have contained the continued growth in public debt. The result is commentators like Streeck striving for new ways to establish a bottom line from which to clarify the politics of public finance. Yet without taking the monetary aspect on board it becomes very difficult to avoid portraying debt politics in instrumental terms.

This is very apparent in how the transition to neoliberalism in Britain is presented which tends to proceed from an assumption that to raise finance the state must make itself credible in the eyes of financial markets, something that is always posed from the creditor side of the creditor-debtor relationship. For that reason, the current literature struggles to conceptualise how state debt - and the state's capacity to monetise it - has worked to empower the state. Critical literature (for example Streeck 2014; Blyth 2013; di Muzio 2016) instead often adopts a framework for analysing debt developed by the classical political economists, one anchored by the problem of 'excessive debt' and its 'unsustainability'. The difficulty it has is in trying to square the theory where debt is unsustainable, with the

experience where state debts have only continued to mount. To contain this seeming contradiction the critical literature presents growing debt as a distortion of an ideal situation, and one that renders debtors vulnerable to creditors in an imbalanced relationship. This leads critical literature to depict neoliberalism as the product of this imbalance. As such neoliberalism is cast as a reaction to the state's excessive debt, and one that empowers creditors over the state, and restricts and undermines the sovereign power of government. A crisis of debt is thus often associated with a crisis of sovereignty (for example Streeck 2014). This, I argue, stems from three fundamental and related misconceptions about public debt, which colours the way scholars understand the transition to neoliberalism in Britain, and its implications for state power.

Firstly, the literature often presents the idea of raising credit as withdrawing from a 'common pool' of resources (most clearly in Streeck, 2014). This is supposed to represent the 'bottom line' that an indebted state has to be wary of and is invoked in the explanation of why states throughout history have had to overcome difficulties with raising revenue, and have at times been subjected to stringent conditions on their borrowing. In that way accounts about public debt often mobilise some notion of a 'real' economic base upon which the size of the financial debt is implicitly measured against. This could be a debt to GDP ratio, or the balance of payments, for example. As a consequence of this 'common pool' imaginary about debt, inquiry into it is often based on the premise that there is a point where healthy provision of credit, becomes an unhealthy dependence on debt. Debt is deemed unhealthy if it reaches a level where paying back to the common pool becomes unlikely. There is, of course, no fixed idea of what the moment of excess is, when good credit becomes bad debt, and it is something that would depend entirely on context. Nonetheless this idea is so deeply embedded into the way debt politics is understood that debt is treated as a potentially scarce resource which by definition makes continually mounting debt unsustainable.

This is a deeply held assumption that remains despite the overwhelming historical evidence that demonstrates how state debt can, and has, been continually piled up, and the realities of the current moment where credit is more abundant than ever. The English crown, when it first raised finance from the London Goldsmiths and then the Bank of England, assumed these loans needed repaying in full and raised taxes to do so in just the way liberal economists warned about. Soon, however, the crown discovered loans rarely needed repaying,

provided debt could be serviced (and often not even that) (Brewer, 1990). It is partly why the original 1694 Bank of England loan to the crown remained on its balance sheets for another 300 years, until 1997 (Choudhry et al., 2003). Though the literature has recognised that monetisation of state debt facilitated its great expansion, well in excess of what could realistically be repaid, there remains the assumption that this distortion must come at a cost. And this assumption colours how scholars understand the neoliberal transition in Britain because it appears as the reaction to that unsustainability.

Secondly, the dominance of this common pool framework and a quantitative imaginary of the debt problem sets up a level of analysis problem. Critical writers especially are keen to emphasise the importance of context-specific institutions and histories, stressing the detail of how and why a state's dependence on credit takes hold, and the way the political consequences of this dependence unfolds (for example Bear, 2015; Streeck, 2014; Lazzarato, 2012). Yet their inquiries are anchored on the assumption of the potential scarcity of credit, which makes it very difficult to look past the power this grants creditors to use financial markets to set the terms of their relationship with the state as a debtor. As a result, critical literatures often depict the institutional developments as unfolding as a response to the imperatives set by credit markets (*ibid.*). In that sense, even when trying to stress the contingency and detail of the creditor-debtor social relation, critical accounts often depict the imperatives creditors set as the ultimate ordering principle. The institutional detail can explain, perhaps, how a state became dependent on credit markets for example, but is not drawn on to explain how those credit markets end up functioning.

Thirdly, when the above two points are taken together, the politics are obscured. The neoliberal transition can easily appear in critical literature as the consequence of excessive public debt; the moment where good credit has turned into bad debt, and left the state in an unhealthy, dependent position in relation to creditors. By this account neoliberal governance is depicted as a regime of governance that helps creditors prevail and deepens the dependence of state and society on credit markets (*ibid.*). For this reason neoliberalism is depicted as a triumph of the interests of creditors over the broader sovereignty of the state and competing social interests (for example Di Muzio, 2016). As such there is a close association between creditor interests in neoliberalism and the depoliticisation of monetary governance. The idea is that when a state abdicates its governance role

to 'the market', it protects the creditor interest from those of other competing social groups.

This adds up to an instrumentalist reading of the politics of debt which again makes it very difficult to conceptualise the relationship between the state as a debtor and its creditors. It also obscures how the state transforms its discretionary power through monetised public debt and how it shapes its relationship with credit markets. Though critical literature aspires to treat debt as a social relation, by negating the monetary aspect of public debt their analyses of the way creditors exercise power through the market makes only one aspect of this relationship visible: the creditor imperative, which is precisely why the discretionary power of the state often fades out of view. This underpins a more general conception of neoliberal governance as a disempowering technology of governance that swept away the practices of the postwar era.

In what follows I use four examples to show how the three problems identified above are perpetuated across the critical literature that uses public debt as a basis for examining the transition to neoliberalism in Britain. In doing so I show that the notion of credit markets as the original drivers of the neoliberal era of governance functions as an analytically obstructive cipher (Appleton, 2015) for the nature of the role played by the state in the process of the construction of this order. As a result, critical accounts struggle to conceptualise the way in which the use of public debt securities worked as a basis for the state's discretionary power and the active role the state played in constructing contemporary neoliberal governance in Britain.

This is necessarily an incomplete survey of the vast literature on the transition to neoliberalism in Britain. Rather, the purpose is to demonstrate how pervasive the problems I identified are. History has shown the enduring sustainability of ever increasing levels of public debt, yet this has not altered the conceptual framework that rests on the idea of the opposite.

Carmen Reinhart & Kenneth Rogoff: Pay your debts

In June 2010, shortly after he had become chancellor of the exchequer, George Osborne made a simple claim that was to underpin his economic narrative for the next decade: "Unless we deal with our debts there will be no growth" (in Skidelsky, 2015). Osborne based this claim on the work of Carmen Reinhart and Kenneth Rogoff (*ibid.*), two neoclassical economists, who in their book *This Time is Different*

(2009) and a related series of papers (for example, *Growth in a time of debt* (2010) and *A decade of debt* (2011)) outlined the problems excessive public debt presents an economy.

The ambition of their work was grand, aiming to develop a theory for the relationship between public finance and economic growth that would hold across historical and geographical contexts. Moreover, the argument they arrived at was fantastically simple: High public debt leads to lower growth (Reinhart and Rogoff, 2010).

Fittingly, the search for a grand theory about the dangers of debt involved compiling data on 44 countries spanning 200 years in what amounted to 3700 annual observations that covered a “wide range of political systems, institutions, exchange rate arrangements, and historic circumstances” (Reinhart and Rogoff, 2011, p. 21). The explicit aim was to cut across contexts and allow the examination of debt to stand as a bottom line from which economic predictions can be formed. Their headline findings were stark: in what they describe as ‘advanced economies’, “the relationship between government debt and real GDP growth is weak for debt/GDP ratios below 90 percent of GDP. Above the threshold of 90 percent, median growth rates fall by 1 percent, and average growth falls considerably more” (ibid.). The impact was exaggerated in ‘emerging economies’, where a 60 per cent debt/GDP ratio brought a 2 per cent decline in annual growth. Or, more simply, there was a systematic correlation between high levels of public debt and low levels of economic growth.

It was on this basis that conservative politicians could beef up their claims about the dangers of public debt and the necessity of paying debt down. As it happened a PhD student, Thomas Herndon, exposed Reinhart & Rogoff for making a serious error in their calculation, but the significance of their contribution is revealing. Excessive public debt comes at a cost and they discovered the quantitative ‘level’ at which debt begins to pose a problem, thereby ‘proving’ its unsustainability. They depict their findings as a mere formal confirmation of the obvious, for if there were no consequences to ramping up public debt (to a 90 per cent level and beyond) then “then generations of politicians must have been overlooking proverbial money on the street” (Reinhart & Rogoff 2011, p. 27).

The reason why debt adversely affects growth is because, they argue, “high public debt burden implies higher future taxes (inflation is also a tax) or lower future government spending, if the government is expected to repay its debts” (ibid., p. 28)



which dampens consumer, household and firm expectations, dragging down growth as a result. This kind of 'debt deflation' continues until public debts drop below the threshold. Until then the debt overhang, as they describe it, casts a shadow over growth even when the immediate threat to the solvency of an indebted government is not in question.

Clear in Reinhart & Rogoff's neoclassical account about the dangers of debt is the lineage to the classical political economists. Like Smith especially, but also Ricardo, their depiction of public debt is that it acts, eventually, as a drain on supply in an economy, undercutting the productive capacity of an economy and the ability of a government to raise sufficient revenue from tax to make debt servicing possible. Moreover, Reinhart & Rogoff share Smith's suspicion of government's weakness for excessive indebtedness and instinct for arbitrary intervention. In *This Time Is Different*, they argue that 'eight centuries of financial folly' have proved that politicians have no aversion to accumulating high debt levels, and Reinhart & Rogoff repeatedly express their concern that excessive debt, if not solved through fiscal retrenchment, will be tackled instead through 'financial repression', that involves forcing a 'captive domestic audience' - usually pension funds - to extend credit to government instead of more productive purposes.

The lineage to classical political economy present in such an idea also displays a curious inversion of the critical depiction of the creditor-debtor relationship. Rather than creditors getting to discipline government and exercising their power through financial markets, excessive debt will lead a government to interfere with and indeed actively restrict the proper running of financial markets through 'financial repression', the result of which is to greatly empower governments and subordinate creditors. There is, in this way, a sense of how governments have the power to shape the terms of their financing, but this power can only be found through withdrawing from the market. A freely operating financial market works as a check on government power, in the classical liberal mode.

Obviously in their neoclassical assumptions and links to conservative political programmes, Reinhart and Rogoff are the subject of much critique (for example Eaton, 2012; Skidelsky, 2015). Yet as I will show, their broad framework that sidelines the monetary aspect of debt altogether, and uses the lens of public debt as a bottom line that can speak in abstraction of institutional contexts, and their reading of the politics of public debt from the perspective of abstract creditors acting on abstract credit markets, is something shared by more critical literatures.

Despite the attempt not to. This is because they share the same foundation of anchoring their inquiries into debt on the assumption that debt must be repaid, something that renders a public borrower vulnerable to the whims of the private creditors acting on financial markets.

Mark Blyth: The folly of dangerous ideas

One of the most influential ways scholars have used debt to anchor an understanding of the shift to neoliberalism has been through the idea of austerity (Bear, 2015). The excessive debts built up by the state are resolved through policymakers adopting a harsh programme of public sector cuts that are eventually supposed to bring the public books back into balance and ensure debts get repaid. The stated purpose of austerity, from those who advocate it, is to rectify excessive public spending, and it is on that criterion that many critical accounts have found grounds to interject. One particularly resonant voice has been Mark Blyth. His 2013 book, *Austerity: The History of a Dangerous Idea*, argued that austerity is a political agenda forged on the misguided notion that public debt is inherently malevolent. The programme of public sector austerity is critiqued on two grounds: First on fairness: the impacts of public sector cuts are distributed unevenly, because those who rely on public sector spending are generally poorer than those who do not. Second on efficacy: if the government cuts public spending at the same time as the broader economy, growth suffers and public debt actually expands. As Blyth (2013, p. 8) writes: “Although it is true that you cannot cure debt with more debt, if those being asked to pay the debt either cannot afford to do so or perceive their payments as being unfair and disproportionate, then austerity policies simply will not work.”

The situation Blyth diagnoses is one where the notion of austerity, a “dangerous idea” with a history he traces back to classical political economy, takes hold of public life. Having clarified how the paradox of thrift makes austerity fail on its own terms, the only explanation Blyth has for its continual imposition is brute ideology. Austerity, as a (poor) remedy for excessive public debt, is imposed by conservative politicians because it enables them to “run the detested welfare state out of town” (ibid., p. 10). At a common sense level this appears persuasive. Conservative politicians, from Thatcher to Osborne to Theresa May, have rarely hid their disgust for welfare and the people that need it. The neoliberal period does seem associated with a particularly punitive approach to welfare provision

(Wacquant, 2012). When viewed through this lens the transition to neoliberalism appears as a triumph of the ideas suited to conservative politicians in 1980s Britain. It is precisely why Blyth places such importance in the influence of the neoliberal theorists like Milton Friedman and James Buchanan. Both articulated a limited capacity of the state to deliver economic growth, and the danger of democracies that allowed non-elites to demand through the state an undue share of resources that can only be met by the state taking on more debt. Blyth argues that these ideas first became dominant in the 1970s, before being put into practice by Thatcher in the 1980s. In this way he casts the transition to neoliberalism, and the imposition of austerity, as anti-democratic and directed in the interest of creditors. As he writes (2003, p. 9) the anti-inflationary politics of Friedman-era Thatcherism was about ensuing “creditors win” and “debtors lose”.

Inevitably such an account depicts the reaction to the state’s supposedly unsustainable debt as curtailing its discretionary power. Blyth rallies against the creditors’ knee-capping of the state’s productive potential and its ability to pursue social good. His whole story is one where the imposition of the austerity idea achieves the curtailing and limitations on the state by dissolving the infrastructure of postwar governance and establishing the liberal conditions classical political economists had always called for.

This makes it very hard to conceptually account for the other side of the relationship, the government as debtor and the way the state has used public debt securities as a basis for its own empowerment. The policy programmes that unfold in the age of austerity become cast as market-led triumphs. It is precisely why his 2002 book, *Great Transformations*, sees the neoliberal period as a triumph of ‘market’ ideas over those (postwar ideas) that emphasised social institutions. In this way the response to excessive debt in the transition to neoliberalism is the emergence of a policy programme of marketisation and public sector cuts that work to empower credit markets over the indebted state.

There are problems with the way Blyth grounds his account of contemporary debt politics as a triumph of the ‘dangerous idea’ of austerity. Firstly, it assumes too neat a translation from policy ideas - and the intentions behind them - to their actual implementation in practice. Secondly, it assumes too much coherence in the ideas themselves, and too much symmetry between such ideas and the interests of a generic class of creditors and conservative politicians. For these two reasons the transition to neoliberalism in Britain appears too smooth and coherent. The difficulty

Blyth creates is that he presents an account where the politics of 1970s and 1980s Britain is a reaction to over indebtedness built up through the decades before, and takes the form of an austerity programme. As such his explanation of the importance of the policies that get enacted proceeds independently of the policies themselves. To fill the gap between the divergent promise of austerity and the practice of increased public spending, increased state involvement and indeed increased public debt, Blyth has to mobilise the notion that the idea is a 'folly', a veil for the real ideology that actually drives the austerity policies.

It is this abstract vantage point that allows Blyth to draw a straight line between the austerity that followed the 2008 financial crisis in Britain and Europe all the way back three centuries to Adam Smith. The empirical content of, say, 1930s Britain was remarkably different to 1970s Britain which was different again to 2008. Though Blyth is highly critical of the classical liberal account of public debt, the fact that the monetary aspects remains occluded means he retains an idea that those concerned about public debt "are not tilting at windmills... why would any state want to carry and pay for such a debt load if it didn't have to? (2003, p. 13). This framing means that it becomes difficult to examine the ways in which the state has empowered itself through debt to reach a point where, for example, at a time when the discourse of austerity ruled, the British state could use its central bank to buy government debt and increase asset prices in the broader economy through the programme of QE. There is no way Adam Smith could have conceptualised such a policy, let alone advocate for it. Episodes of QE in Europe and America, where state institutions did appear to have a discretionary power to shape credit market relations, Blyth sees as temporary and scarcely relevant. The fact that the state was able to do that in 2008 but not in the 1970s speaks to the way its discretionary power grew, rather than shrunk in the period that followed the transition to neoliberalism. Blyth does not provide a framework for examining this precisely because he is limited by the terms of classical political economy that he aims to critique.

Geoffrey Ingham & Jeremy Green: The City-Bank-Treasury nexus

An alternative approach is one that sidesteps questions of grand ideology, and instead roots the shift to neoliberalism in Britain in what aspires to be institutional terms. This depicts the neoliberal transition as the driven by the longstanding power of the financial sector - and international financial interests - in Britain's political

economy. This is a perspective developed by Geoffrey Ingham's (1984) work on the historical dominance of the City-Bank-Treasury nexus in British capitalism, that has been recently expanded upon by Jeremy Green (2013; 2016), who argued that American finance became an important part of that nexus after the second world war.

In this view the British state has long pursued 'monetary discipline' over all other priorities. This stems from the overlapping interests of the City of London, the Bank of England, and the Treasury in the promotion of international finance. The nexus has overpowered productive and manufacturing interests throughout British history via a pursuit of monetary discipline and liberalised financial markets that ensured a 'stable currency', and the "unwillingness [of the state] to regulate the City's activity in any effective way" (Ingham 1983, p. 41). The commitment to monetary discipline was historically articulated through the interest in 'sound money' and manifested itself most importantly with the establishment and maintenance of the Gold Standard. After the second world war, when Britain's financial position in relation to the rest of the world reversed, and America took over, monetary discipline was forced through by American financial interests. This American aspect of the financial sector's postwar dominance was explored by Green (2013) who describes how Britain was integrated into an 'Anglo-American developmental sphere' that centred upon a collaboration between the financial centres of New York and London.

Green argues that the British state had the option, after the second world war, to break with a historical dominance of the City-Bank-Treasury nexus, but did not take it because of its dependence on American credit. Britain's bilateral debts with America gave the latter great bargaining power over the construction of the postwar monetary order, and in particular, the plan for sterling convertibility (into the dollar that dominated world trade). This left sterling forever vulnerable to international speculators throughout the postwar era. Rather than capitulate entirely, Britain established a role for its financial sector through the Euromarkets and it was in this space that the updated, Atlanticised City-Bank-Treasury nexus reasserted itself.

The Euromarkets allowed the City to flourish irrespective of what happened to the broader British economy, and indeed the value of sterling. Moreover, it provided the opportunity for American power to shape British capitalism. British banks were only able to maintain their international standing by switching to the

dollar which “led to a synthesis of Anglo-American banking practices, increased Anglo-American interest rate interdependence and constraints upon the autonomy of policy makers on both sides of the Atlantic” (Green, 2016, p. 433). The integration of banking practice, and dependence on American credit, meant that American financial interests were in a privileged position to push forward the kind of regulatory changes that they and their partners in the City wanted. Moreover, the Bank and the Treasury were locked into a dependence on American financial institutions, which drove what Green describes as more ‘liberalised’ and ‘marketised’ forms of finance in Britain. Ultimately, the establishment of market finance provided a ‘natural basis’ for Thatcher to complete the liberalisation of finance and ‘re-impose monetary discipline’ to Britain after three decades. In doing so any hopes of industrial modernisation were curtailed.

The basis for the entire analysis is to demonstrate how the institutional evolution of Britain’s political economy privileged the financial sector over competing interests. In the effort to explain why Britain’s manufacturing sector had declined and was unable to revive despite favourable conditions after the second world war, Ingham and then Green present the nexus as the ultimate block. As such they necessarily paint the emergence of neoliberalism in Britain as something established by the institutional privileging of financial interests, to serve financial interests, irrespective of the costs to society as a whole. Monetary discipline is pursued because it suits the interests of creditors, and financial deregulation and attempts at monetarist governance are all part of that same exercise in creditor power. The problem with such an account is that it risks an instrumentalist depiction of financial politics, that relies on an overall coherence of interests in the financial sector, and the ability of the financial sector to simply translate that interest into action. The notion drawing all this together is that of ‘monetary discipline’, which is supposed to have acted as a check on the discretionary power of the state historically before the second world war, and again after Thatcher re-imposed discipline in the 1980s.

Yet the reality of monetary discipline differs from the conceptual ideal. During the period of the Gold Standard government budgets were not balanced, rather the public debt expanded greatly. Similar happened during Thatcher’s experiment with monetarism when government budgets were mostly in deficit and private credit expanded rapidly. Perhaps more significantly both the gold standard

and monetarism were attempts to control private sector finance. It is peculiar, then, to depict monetary discipline in instrumental terms.

Part of the problem is that Ingham and Green's accounts sideline the way debt issued as money has historically empowered the state. It is only from that basis that they can depict a fundamental contradiction between the interests of finance with those of democracy. The assumption runs that credit can only be provided in conditions of a stable currency, which can only be guaranteed if the state steps back from social provision or economic intervention. Both these conditions are assumed rather than examined and leads their accounts to emphasise how the financial nexus of power lifts the operation of the state out of popular democratic scrutiny with the move to neoliberal governance working to take monetary politics out the realm of formal democratic institutions.

This incredibly broad framework exists in abstraction from the specific policies that unfolded. In Green's account there is detailed historical description of the practice of American and British financial actors, but the history does nothing to shift the (already well established) notion that neoliberalism amounts to the imposition of monetary discipline. Ultimately it is still in that sense a reading of the politics of finance from the perspective of creditors, where creditor interest in 'sound money' is depicted as the ultimate force driving monetary politics. As such it becomes very difficult to conceptualise the state, how it acts and to what ends. On this basis the only way to account for the discretionary power of the state is to assume that government gets mobilised by creditors for their own ends. This is precisely how Green depicts episodes of state power like the Big Bang re-regulation of London's securities market in 1986 (Green, 2013) or the contemporary Conservative government's austerity and QE programme (Green and Lavery, 2015)

Wolfgang Streeck: The crisis of the debt state

The final example comes from a rich strand of Marxist scholarship that analyses the politics of the state's indebtedness and the transition to neoliberalism within the broader dynamics of global capitalism. From this perspective the state's growing dependence on debt comes from its declining tax revenue, which itself comes from the secular crisis of capitalist profitability since the 1970s. Without a growing tax revenue to draw on, governments across Global North are structurally dependent on international creditors for finance, who use this leverage to force through a reorganisation of society in their own interests. The transition to neoliberalism is the

moment at which the debt amassed by the state left it suddenly over-dependent on creditors, who, now equipped with market power, leapt at the opportunity to force through social change. This account has been made most influentially by Wolfgang Streeck in his 2014 book *Buying Time*.

Streeck articulates his argument by referring to aggregate ratios of debt to GDP across OECD countries, and references to the relative composition of OECD governments' tax and debt financing ((Streeck, 2014a; Streeck, 2014b; Streeck, 2015). The case he makes is that good credit becomes bad debt when a government becomes over dependent on debt financing because of a declining tax take. His is an explicitly abstracted argument that cuts across different countries with vastly different institutional contexts, and is based on what he considers to be a Marxist twist on the classical 'common pool' story of public credit. Governments finance their spending through tax revenues and debt, and the former relies on there being sufficient value created in the broader (private) economy which the state can draw through taxes on income and profits. As profits decline, and wages decline, companies and individuals are less willing to pay taxes to the state. This 'tax rebellion' and the growing anti state sentiment that seemed to form around the 1970s forced this potential tax revenue down, which deepened the problems caused by the 'ultimate' issue: the decline of capitalist profitability and the "subsequent inability to honour the promises of economic and human progress on which [the state's] legitimacy depends" (Streeck, 2014b).

With no tax revenue to turn to the state is dependent on debt from private financial markets. The important innovation Streeck makes at this point is in recognising how sustainable this situation has proved. Financiers have been happy to bestow on governments the finance needed to meet government's spending commitments, and more often than not, the money to meet debt servicing costs too. Indeed, as Streeck argues creditors do not want the government to be free from debt. Rather they want a government with the ability to continually service a growing pile of debt. It is the wealthy who buy government bonds and in doing so find a safe haven for storing the value of their wealth, while earning a return through receiving interest. This has allowed the state to continue to borrow ever increasing amounts. Such rollover debts are the creditors' ideal. Moreover, they gain twice because they also do not pay out as much in taxation.

Despite this apparent abundance of public credit, Streeck having established a common pool framework, still relies on the potential scarcity of credit



for his account of why creditors dominate. He conceptualises creditors as a 'class' that organises its interests on financial markets, similar to the activist shareholders in the corporate world who, under their doctrine of shareholder value, have distorted corporate strategy to maximise their own returns. In public life the 'market power' of bond-holders allows them to use credit markets to push their claims ahead of other citizens. Much as businesses could threaten an 'investment strike', bondholders could threaten a 'bond buying strike' and this power is used to force governments into serving creditor interests.

There is here, an interesting tension where, having shown how states can 'buy time' through loading up debt (and have done so for nearly four decades), he still treats the threat of a 'bond buying strike' – effectively the power of 'exit' – as the key principle to understand the politics of the debt state. Since the financial crisis, he argues, OECD states have no more time to buy and instead must face the consequences.

Neoliberal rule is one where the creditor imperative trumps all, where the 'Marktvolk' trump the 'Staatsvolk' and democracy is sacrificed at the altar of financial markets. Streeck explanation of the triumph of creditors differs from pure ideological triumph, in the way Blyth (2013) described, and from the account of financial power in Britain that Ingham (1984) and Green (2013) outlined. Rather Streeck's suggests a secular problem that affects all OECD countries, of which Britain is just one. The fact that the state has successfully expanded its debt and, in the case of Britain and America, can draw on credit at very low prices, does not alter that politics of neoliberal governance as Streeck sees it. The power of the state exists only to function creditors, and debt exists only to fill in the gap created by the secular crisis of growth in capitalism. Moreover, because his analysis proceeds at a highly abstracted level Streeck makes no attempt to examine how different creditors might have different interests, or how particular policies of financial deregulation and fiscal contraction specifically chime with creditor desires.

Though Streeck makes passing mention of the state's role in creating money through its issue of public debt, this occupies a footnote in his account that remains anchored on a classical idea that a state issues debt from a base of resources, and as such the monetary aspect is negated. The result is a necessarily highly instrumentalist reading of debt politics that sees only the creditor side of the creditor-debtor relation, and is founded on the idea that the problem of debt stems from its unsustainability. As I have argued throughout this assumption has actually

proved historically problematic. The British state has long been reliant on debt, but historically this has been issued as a form of money and has worked to greatly empower the state (Braudel, 1982; Brewer, 1990). The monetary aspect makes the political dynamics harder to account for than in Streeck's framework. Britain, for example, was heavily indebted in the period after the second world war but this was not a time when creditor interests, in Streeck's formulation, were dominant.

One possibility not explored by the authors is to avoid separating out the monetary aspect of public debt. This would allow for an account more comfortable with the historical experience of the British state continually piling up a mountain of debt. In turn this forces a departure of the unsustainability foundation, and reconceptualises what was involved in the emergence of neoliberal techniques of financial governance in Britain. Rather than a response to the unsustainability of public debt, I argue, the construction of neoliberal governance in Britain took place in the context where the state was finding ways to extend the size and liquidity of debts. As such it is misleading to ground an understanding of neoliberal governance on the idea that it involved a restriction of the discretionary power of the state.

#### 1.4 Rethinking the debt state

The four literatures I outlined above demonstrate the problems with the way existing approaches have tried to use public debt as the basis for understanding the shift to neoliberalism in Britain. Simply, it becomes very difficult to conceptualise both sides of the creditor-debtor social relation when the moneyness of debt is occluded. The politics of debt is instead read in terms of its 'excess' and 'unsustainability'. Such an unspecific and ultimately normative anchor makes the creditor imperative of repayment seem overwhelming, and it follows that a condition of indebtedness is read predominantly in terms of empowering creditors. Despite historical findings that have demonstrated how the institutionalisation of the monetary functions of public debt has allowed the state both to sustain vast and growing levels of debt and govern liquidity in the economy more broadly, the literature remains entrenched in the tenets of the classical liberal political economists it intends to critique.

The result is that the transition to neoliberalism is presented in quite instrumental and abstract terms: For Blyth (2013) it was the ideological project forged on the 'dangerous idea' of anti-state austerity. For Ingham (1984) and Green

(2013) it was an outcome of the historical domination of financial interests in British capitalism and its postwar dependence on American credit, which gave financial institutions of both countries the power to liberalise finance in the pursuit of monetary discipline. And, for Streeck (2014), the transition to neoliberal governance came from the inability of capitalism to deliver the growth that would support the government's tax revenues. A state had no choice but to take on excessive amounts of debt which gave creditors the power to script political economic reform in Britain. Each perspective risks an instrumental story of debt politics where the power of the state is repurposed by creditors for their own use. In this way neoliberal governance appears as a case of governments ceding discretionary power to credit markets.

This thesis moves away from such assumptions and aims to recover the monetary aspect of public debt that demands a more rebalanced reading of the creditor-debtor dynamic. To do so I argue that precisely because of its monetary functions, understanding the politics of public debt means switching the focus away from the question of solvency, and the steps a state must take to ensure it remains solvent, to instead explore credit and debt relations as a question of liquidity. This means examining the process by which public debt acquired monetary functions and the governance infrastructure this created. Taking seriously the moneyiness of debt means abandoning the notion of the 'common pool' of resources that the state can only erode when it raises debt finance. In simple terms, it is misguided to base our understanding of credit in terms of its potential scarcity, when the last four decades have been near defined by the abundance of credit in the financial system. In that sense unlike previous debt-based inquiries into the neoliberal transition I focus not on the power of creditors in financial markets, but on how the state as a debtor has used public debt as a basis for its own empowerment. As I will show, the construction of neoliberal financial governance in Britain did not entail the state passively devolving governance responsibilities to credit markets but instead entailed a process of the state trying to empower itself and gain leverage over financial actors to give itself greater flexibility in the control of the monetary aspects of its debt.

As such the methodological contribution the thesis makes is to establish a framework of inquiry capable of grasping the politics of public debt without separating out the monetary aspect from debt. My focus on the role of the state, as a debtor, is not posed in terms of regulation (or more often deregulation) as in the

current literature (for example Bear, 2015; Streeck, 2014b; Streeck, 2014a). Instead I follow Knafo (2013) in prioritising 'empowerment' because, as I will show in the chapters, debt could not grow in a vacuum of institutions, rather the capacity to borrow, refinance, service and repay public debt, had to be constructed. The repayment imperative alone, and the focus on credibility it necessitates, says nothing about what kind of institutions were created in response and nothing about their political implications. State institutions develop techniques of monetary governance in a pragmatic and piecemeal manner, solving particular policy problems they confront at different moments, and never with a pre-formulated grand strategy. As such, these techniques and their importance cannot be grasped in abstraction by appealing to notions of 'creditor interests' or 'debt dependence' or indeed 'monetary discipline'. Rather the importance of these techniques are better grasped by assessing how they related to the monetary infrastructure through which the state had developed a means to govern the broader economy.

There is a difficulty with historicising the social relations of debt that this thesis has to overcome. The recent scholarship clustered around David Graeber's (2013) highly influential anthropological history, *Debt: The First 5000 Years*, has tried to show how contemporary society is uniquely structured by the creditor-debtor relation in a way that was not the case previously (for example Lazzarato, 2012; Di Muzio, 2016; Soederberg, 2014; Hager, 2016; Bjerg, 2015; Streeck, 2014a). Despite different theoretical inflections they outline how creditors have developed the whip hand over society, and anchor their accounts on the notion that creditors' structural power over debtors equips them with the capacity to dissolve all other social relations and transform a political economy, disciplining its subjects so as to make debt repayment the fundamental principle of society (Lazzarato, 2012).

There exists a deep theoretical assumption that creditor power emanates from credit markets, and the more markets expand the more power creditors have. There is a tendency, as a result, to lend too much weight to the capacity of creditors to script public life to their choosing. When the social relations of debt are read off market dynamics, examination into debt politics too often becomes an examination of the size of credit markets, a quantitative issue, rather than an exploration of the relations that get established through credit market socialisation (for example Di Muzio, 2016; Hager, 2016). In this framing, the politics gets 'filled in' external to the market socialisation, by diagnosing how and why 'restrictions' on market expansion were lifted. Empirical detail matters only in the terms laid out by the framework of

the market power of creditors, which means that the accounts that do mobilise empirical detail, be it ethnographic (Bear, 2015; Montgomerie et al., 2015), historical (for example Soederberg, 2014) or political (Chick and Dow, 2013), focus on debtors as victims of a rigged system (Streeck 2014) and creditors generally as an aggregated and unspecified social group constituted by and acting through credit markets (Hager, 2016). Not only does this rely on too coherent a conception of creditors but also relies on the idea that creditors are readily distinguishable from debtors, which in the age of securitisation is simply not the case. Moreover, accounts of debt dependence necessarily mobilise the idea of a structural market relation that presumes creditors' ability - and debtors' inability - to act and shape their context. Yet the ability of creditors to act does not come from a market position and must instead be constituted. Similarly, debtors can mobilise financial markets for their own ends to shift the context in which they operate. In the structural framing the only way a debtor can gain room for manoeuvre is by exiting the market (for example Lemoine, 2016).

It is precisely because empirical material is made to follow a rigid theoretical framework of creditor market power that debtors have fallen out of the picture in the literature. In this thesis I recover the power of the state by examining how public debt came to serve as money and how the monetary infrastructure that emerged as a result provided the state an avenue to intervene into the economy. Consequently, the expansion of indebtedness cannot be conceptualised as a dissolving of social relations and the transformation of a clutch of non-economic social institutional bonds into an economistic creditor-debtor relation that is upheld by the abstract rules of the market. Rather the expansion of indebtedness means a further complexification and intensification of social relations (Konings, 2015), the development of new institutions and new connections that bind disparate actors together in the political economy. In the case I examine in this thesis, the British state as the debtor, these relations of credit were used to form the basis of economic governance.

As such, following Knafo (2010, 2013) this thesis argues that relationships like a state's dependence on credit markets should be read in terms of power: how agents gain the capacity to act. This does not imply voluntarism, it is not that a debtor, even the state, can, consequence-free simply opt-out of its obligations to creditors. Indeed, policy debate is often articulated in terms of the limitations to which governments were subjected. Yet it is in responding to these impositions that

states develop policies and institutions that aim to try and make themselves effective on credit markets. As I demonstrate through the thesis, the difficulty of establishing the capacity to do so means there is always a necessary disjuncture between the policy intentions and policy outcomes. For this reason, it is more revealing to examine policies in terms of the means of their implementation, rather than the intention of policymakers.

Through the thesis I trace the evolution and strategies and institutions developed by the British state in its effort to raise debt and ensure its stable financing. By revisiting the history, I hope to build an understanding of neoliberal monetary governance that is sensitive to the moneyiness of public debt and thereby breaks out of the idea that the state's dependence on debt made it a helpless agent of the creditor class. In doing so I show how the construction of neoliberal financial governance was shaped by the state. In that sense the thesis mobilises history to provide a theoretical contribution of bringing the state 'back in' to the story of debt politics, and the broader argument that states play a role establishing and reproducing markets (Panitch and Gindin, 2012). It shows how public debt is a basis of state power.

## Conclusion

It has proved very difficult to come to terms with the monetary aspects of British public debt. Though the British state has been successfully monetising its debts for three centuries since the Financial Revolution, the implications this holds for public finance have been difficult to comprehend. Put simply, while many may now be comfortable with the idea that money is a form of debt, there is a tendency to neglect the other side of the coin, the way debt can act as money.

For that reason, commentary about public debt has been gripped by the challenge of establishing the 'limit' to the level of borrowing a nation can sustain. This led to a depiction of the national economy as a common pool of resources that government draws from whenever it raises debt. The more notes it issued the more it etched away at the common pool and the more distant the monetary world of bank notes grew from the underlying real economy. Unless the productive capacity of the nation developed, growing the common pool of taxable resources, increasing public debt will court disaster, be it inflation or default. The result of which is to supposedly leave indebted governments striving for ways to 'prove' to creditors that their policies would grow the economy, avoid inflation, and lead eventually to less

dependency on external finance. Neoliberal reforms are cast then as examples of governments trying to reorganise their political economies in pursuit of this credibility.

Yet taking into consideration the monetary features of public debt throws the entire question of debt politics into a different light. Because if debt can readily circulate as money, its possible redemption becomes a less pressing concern. Rather if public debt is used as money it provides the state with power not just to finance its own outgoings, but a scope for much broader governance of liquidity in the economy as a whole. For precisely this reason the British state has been able to repeatedly ramp up its borrowing, well past the level at which repayment could be reasonably accepted, without crippling inflation or threat of explicit default. This offers a different vantage point from which to consider the emergence of techniques of neoliberal financial governance in the 1970s and 1980s. The question becomes less one about what sacrifices were necessary to acquire credibility in the eyes of international financial markets, and more about how the public debt acquired monetary features, and what role the state played in the gradual institutionalisation of monetised public debt. From here it becomes easier to see what interests the state had in the development of neoliberal techniques of financial governance. In the next chapter I begin this process by first exploring how public debt acquired monetary features through the seventeenth century Financial Revolution, and how public finance shaped the development of banking in Britain over the centuries that followed.

## 2. The long history of the British debt state

### Introduction

The British state has a long history of debt. If, to use Wolfgang Streeck's (2014b) terminology, a 'debt state' is one dependent on borrowed money, Britain has been something of a debt state for over three hundred years. Yet rather than present a problem, the growth of its public debt has been a basis for a great empowerment of the British state. This is because the Financial Revolution and the establishment of the Bank of England in 1694, gave the state a unique capacity to borrow on the basis of issuing banknotes. This monetisation of public debt meant debt could stretch well past the levels at which repayment could ever realistically be expected. This unleashed a very particular monetary dynamic in Britain that shaped the development of its financial system and the possibilities of public finance and economic governance. The longer history of public finance in Britain is easy to overlook in the familiar framing of British industrial decline, where Britain's growing debts are taken as yet another sign of its waning economic significance (for example Schenk, 2010). Once a powerful creditor to the world, by the end of the first world war it had amassed vast liabilities to itself and the wider world (Cairncross, 1991). In this story Britain's debt is a burden that grew heavier as empire receded and industry declined. External balances were a theme that dogged governments throughout the postwar years and many authors use this as a template for considering the hegemonic transition from Britain to America in the twentieth century (for example, Schenk, 2010; Green, 2016).

This chapter throws the issue of indebtedness into a different light by examining how public debt acquired monetary features through the Financial Revolution and how this shaped the gradual integration of public debt into the broader economy. It is well established that debt and money are intrinsically connected. Indeed, the notion of money as a form of debt is foundational to a large branch of critical political economy. Yet there is much less clarity over what it means to examine the moneyness of debt historically. By tracking concretely how public debt became money in Britain, and what implications this had, I begin the



process of historicising the moneyiness of debt. This is an especially British (and English, initially) story because it was the specific changes in the nature of money in Britain which emerged through the development of banknotes that underpinned the Financial Revolution and the establishment of the Bank of England. It is why the British classical political economists are so significant in shaping monetary thinking and why there was to become such a rich lineage of monetary thought in Britain in the centuries that followed.

Through the chapter I demonstrate the necessity of conceptualising the monetary aspects of public debt in a specific way. What mattered was not simply that public debt was used as money, but that this shaped the development of financial institutions in the country and worked to provide the British state a unique avenue for intervention in what became a broad national economy. As I show the national debt was central to the formation of a national system of banking and finance in Britain, and this worked to empower the central government, laying the foundations for what became the Keynesian revolution. In this sense I use this chapter to examine more deeply the fundamental, revolutionary changes that took place in the period between the time the classical liberal political economists raised their concerns about public debt, and the postwar period in Britain that is my focus. In doing so I show how the politics of public finance has never been simply about the state taking the necessary steps to establish credibility in the eyes of financial markets.

The chapter is divided into three sections. I begin by examining the emergence of state debt in England in the Financial Revolution and the monetary politics entailed in the foundation of the Bank of England. I draw on Samuel Knafo's (2013) work on the rise of the Gold Standard to show how England's early financial development was shaped by banknote issuing. The second section examines the rise of a national banking system centred around the clearing banks, the discount houses and the Bank of England. This put one form of national debt securities - paper money - into the heart of the banking system. A new dimension to the debt state emerged as the relationship between liquidity and the monetary base in gold loosened. In turn this opened a new aspect to the operation of debt management because the national debt became embroiled with liquidity control. The new institutional linkages that emerged helped develop a new capacity for the state to use debt management to intervene into the economy through adjusting liquidity. In the third section I show how this dynamic was magnified through the enormous

expansion in Treasury Bill-financed first world war debt, while again another dimension to the debt state was added through the emergence of intergovernmental debt, especially Britain's war debts owed to America. This meant the operation of debt management had to speak not only to domestic liquidity but also external liabilities and the issue of convertibility.

## 2.1 The origins of public debt

The Financial Revolution of the seventeenth century was crucial to establishing a unique trajectory for British political economic development. Through the revolution the British state established the ability to issue its debt as banknotes, dramatically shifting the politics of public finance as a result. The revolution, which occurred as part of a sophisticated financial architecture based on discounting that took hold in England, established the possibility for the state, as a debtor, to greatly empower itself through borrowing vast sums sustainably. It was this financial power that John Brewer explored in his classic work *The Sinews of Power* (1990). Brewer outlined the broad links between state power and the financial system by demonstrating how Britain's military capacity grew alongside the Financial Revolution. He argued that through the development of a sophisticated and centralised regime of tax collection, the English state was able to establish a collateral on which to secure vast public credit, which funded its repeated wars in the seventeenth, eighteenth and nineteenth centuries. In this respect Brewer successfully demonstrates how the state was able to use debt. Yet he and others (for example Dickson, 1993) depict the Financial Revolution as part of the broader Glorious Revolution in England that put in place the contours of the liberal state. In traditional readings the liberal state is supposed to be limited. As such Brewer squares the contradiction of the growing power of the state that he identified, and its supposedly liberal formation, through the idea of 'credibility'. He argues that the fact that the state could raise credit in this way was forged on - and symptomatic of - the faith private financiers had in the credibility of the state and the newly formed Bank of England, that would protect them from arbitrary extraction by the crown. Brewer's account is typical of the way public debt is treated, where the state's debt-raising capacity is read off a template of 'credibility'. It shapes how Brewer reads the monetary politics of the Bank of England, which for him emerges precisely because of the crown's commitment to maintain sound money and resist any attempt to debase and inflate the currency.

The Bank itself is taken as a classic marker for textbook histories of public finance because it seems to epitomise the early emergence of England as a 'liberal' state. Yet the origins of the Bank of England and the way it developed with the gold standard challenges this story. To recall the Bank of England was established in 1694 when William of Orange borrowed £1.2 million to fund war against France. This is often presented as the first 'public loan', with the contemporary public explainers stating that its founding loan can be thought of as the first 'gilt' issue (Choudhry et al., 2003, p. 1). The loan was raised at 8 per cent in perpetuity and, somewhat incredibly, remained on the Bank of England's balance sheet for another three hundred years (ibid.).

Yet public debt did not begin with the Bank of England. And, as Knafo (2013) outlines, it is more fruitful to read the establishment of the Bank in the context of the broad transformation in English finance brought about by the rise of discounting, rather than as the manifestation of the credibility brought about by an emerging liberal state. When viewed from the generic perspective of abstract 'creditors', seventeenth century 'credibility' was a question of ensuring sound money: that metal currencies were not debased and that discounted bills of exchange would be redeemed into the agreed weight in gold. This theory would assume that the crown's commitment to sound money would empower financiers as creditors, and help establish the conditions for the financial sector to develop in Britain. Yet the history worked out the other way, because the way 'sound money' was pursued actually undermined financiers. When read in terms of the specific struggle within the English state between landlords and the banking community, the politics of sound money are better understood. The crown's commitment to sound money came not from financiers as creditors, but came from the way landlords, not wanting their rents dented by inflation, lobbied the state. Indeed, such was the power of landlords that even the fiscal capacity of the crown was undermined because landlords had grown wary of constant taxes on land, and used the power of parliament to make it harder for the crown to extract revenue in this way. As such the crown was forced to turn to other sources of financing - notably mercantile companies - which posed a challenge to the sound money framework which had underpinned state intervention. Merchants had found it difficult to trade English exports (of wool etc) for Asian goods and as such relied on specie (silver coins, mostly) for payment. Previously, during the Middle Ages, merchants predominantly exported English goods and returned with specie. This worked well in a context

where the crown's pursuit of sound money meant it had banned the export of bullion. However, once the merchants' dynamic reversed, the policy became a problem. The merchants needed to export specie if they were to import goods from the East but the crown wanted to pursue sound money and maintain the value of the pound. The limits on money exchange and minting of specie meant there had been frequent financing and liquidity problems for both the state and private business.

It was in this context that the development of discounting that had begun with the London Goldsmiths and found institutional form politically through the establishment of the Bank of England should be read. The Goldsmiths had established themselves as safe-guarders of wealth assets - gold, silver and other jewels - which was especially important in the fervent political environment of revolutionary England. As Knafo (2013, p. 88) outlines:

“Goldsmiths accepted bills of exchange from merchants and gave in return promissory notes that were convertible into gold. These banknotes were probably issued initially as a convenient means to deal with the shortage in means of payment. They quickly began circulating within mercantile networks of London, and gained credibility as means of payment.”

What the London Goldsmiths did was to hand out banknotes instead of coins when they discounted bills of exchange (Knafo, 2013, p. 54). Their deposits were the foundation for the development of a significant growth in liquidity. Using the capital they stored they extended credit to feed the growing liquidity demands of the merchants and then, the expanding financial needs of the state.

This is pivotal because it is here where you see state debt first acquire monetary functions, and transformed the ability of the state to borrow large sums sustainably as a result. The implications were startling; in effect the state could finance itself by creating money 'out of nothing'. There has been much debate<sup>3</sup> about how to conceptualise this, but whether viewed as credit money, or fractional reserve intermediation, the practice of lending money as notes rather than coins transformed the sound money/limited liquidity problem, because the same amount of specie could transform into greater liquidity. Goldsmiths were drawn on to

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<sup>3</sup> The financial practice established by the Goldsmiths has been variously described as fractional reserve banking, 'real-bills' intermediary banking, or more recently an early development of securitisation. See Werner (2015) and Sgambati (2016) for a full discussion.

provide liquidity to the state, using banknote issuing to discount treasury bills issued by the state. As a financial practice that was removed from currency exchange it was an innovation of, and suited to, the sound money regime (Knafo, 2013). For this reason, the pre-history to the establishment of the Bank of England matters, because it was the development of the practice of banknote issuing that was institutionalised through the Bank of England, and it provided the state an enormous flexibility in financing.

The brute numbers tell a story: At the end of the Nine Years War in 1697 government debt stood at nearly £17 million and over the century that followed the national debt grew rapidly. By 1793, unredeemed public debt stood at an unprecedented £245 million, a fifteen fold increase (Brewer, 1990, p. 94). Moreover, the interest rate on public debt fell substantially, from 8 per cent to 3 per cent between 1694 and 1750 (Knafo 2013, p. 82) and the scheduling of debt was transformed. Between 1688 and 1697, 70 per cent of the Crown's debt was on short-term contracts, this had fallen to 14 per cent by the time of the Austrian succession wars of 1739-1748 (*ibid.*, p. 91). In this way the fiscal operations of the state (which were overwhelmingly directed at warfare) were underpinned by debt. Indeed by the time of the American war 40 per cent of public expenditure was funded by loans (Brewer, 1990, p. 94). In the contemporary terms of Streeck (2014b), eighteenth century Britain was very much a 'debt state' and its level of indebtedness - enabled through banknote issuing - far exceeded other European countries, whose public banks still revolved around monetary exchange and clearing. It was what fuelled England's political dominance in the region (Mann, 1986 in Knafo, 2013). England's reliance on debt was not unique. Rather it was the fact that this was debt issued as banknotes that marked it out (Knafo, 2013).

## 2.2 Debt management after discounting revolution

The emergence of this early 'debt state' set up a particular dynamic for the English state that did not exist previously. Its ability to issue its debt as banknotes meant that the management of public debt soon became a crucial apparatus of statecraft. I focus here on the way the state developed a capacity to raise and sustain large debts and what institutional connections were forged through this, which could later be repurposed for policymaking. Debt management consisted of two channels and involved mobilising different social coalitions. First, there was an effort to reorganise, repackage and rollover loans to extend their maturity and lower their

interest rates, which entailed partnering with the goldsmith bankers. Second, there was ensuring the continued stability of the underlying collateral, which was the constant extraction of private wealth through taxes and Crown licensing of incorporated 'public companies'. This extractive taxation is the familiar problem with debt laid out by the classical political economists and entailed partnering with merchants and needed parliamentary support. Taken together these two strategies of managing the growing public deficit spawned political tensions between landlords and merchants, a conflict that is covered in depth by Knafo (2013). My focus is on how, given its monetary aspects, the operation of public debt management resulted in the state assembling a particular capacity for intervention. Initially, I argue, though the state tried to develop refinancing strategies, its primary mode of debt management was extractive, fiscal interventions of the classical imaginary.

To begin I focus on the effort to improve the terms of debt financing and the growing role this provided merchant bankers. The initial loans made to the crown by the Bank of England and the goldsmiths that preceded it were self-liquidating annuities (Caselli, 2015). Their success was helped by the establishment of a secondary market for government debt. This involved the incorporated bodies of public creditors, led by the Bank of England, developing a securities market in London that allowed lenders to sell their public (or merchant) debt onto third parties. This secondary market was crucial in getting the government's system of long-term financing off the ground (Dickson, 1993) and integral to the growing sustainability of public debt because it improved the liquidity of debt securities. There were clear advantages for private firms, like the Bank of England, to partner with government. Secured against tax revenues as they were, public loans were comparatively low risk and guaranteed their holders a regular income, which in turn provided them with enormous power in the private money market (over other creditors). Indirectly underwritten by the state, merchant banks could dominate the private lending market. There was, as a result, much competition among private companies to try and collect a larger slice of the public debt market (Knafo, 2013).

"In 1707, for example, the Sword Blade Company tried to wrest part of the debt away from the Bank of England. The incorporated creditors also fought amongst themselves for a larger slice of the fiscal pie. In the same year that the Bank of England had to fend off the attentions of the Sword Blade Company, the East India Company orchestrated a run on the Bank to weaken its rival" (Brewer 1990, p. 97).

With the market for public debt seemingly strong, successive governments tried to

repackage short-term loans into a single fund to extend their maturity or lower their interest rate. For example, Walpole established the Sinking Fund in 1716, which initially was supposed to be about building up a 'war chest' from which to pay back the principle on public debt, but quickly transformed into being a fund for restructuring the debt instead (Brewer, 1990). Moreover, the partnership with merchant bankers helped management of the public debt because their administrative and bookkeeping methods were better suited to the new practices of discounting than the more cumbersome procedures of the Exchequer (Brewer 1990, p. 97). It shows an early awareness that intervening in the liquidity of debt could be used to 'buy time' before its repayment, but at this stage the state's engagement with these kinds of monetary techniques of debt management were fairly rudimentary and it was more concerned with the second channel of debt management more familiar to the classical liberal imaginary: taxation.

It was still taxation and incorporation licences that underpinned the security of the note issues and formed the backbone to the state's operation of debt management. As such specific taxes were raised for the purpose of underwriting and repaying public loans. This was in part due to the uniquely centralised tax system in England (Wood, 1981), with uniform fiscal arrangements across the country ensuring that taxes were levied on a national rate, allowing greater consent to the system of taxation and making revenues more predictable and loans secured on their revenue more stable (Brewer, 1990). As taxes on land became harder to levy because of the resistance of landlords in parliament, many of the new taxes it raised were indirect taxes on consumption. Indeed, the use of the Sinking Fund to lower borrowing costs, rather than actually pay off the national debt, reflected the authorities' changing attitude towards public debt and the gradual acceptance that it was becoming a permanent part of public life. The other extractive mode of debt management was to charge companies for incorporation, with the East India company, the South Sea company and indeed the Bank of England, all having to pay for the privilege of having the licence to, for example, trade in the name of the Crown. Yet, as Knafo (2013) describes, the problem with this dependence on fiscal means of management was that it exacerbated the clear tension between the extractive power of the state and private merchants.

The growing acknowledgement of the debt and an understanding of fiscal means of sustaining it did not translate as yet to an understanding of a more 'monetary' approach to intervention into the broader economy. While the state's

fiscal extractions were distributed fairly evenly across the country, monetarily, the state's interventions and partnerships were all clustered around the City of London and the merchant banks. In that way the operation of debt management and the discounted bills issued by the Bank of England were fairly removed from the monetary system more broadly. It was not until the nineteenth century that the Bank of England and the system of discounted bills hooked into the broader industrial English economy outside of London (Knafo 2013). It is this 'monetary' operation of debt management, and the coordination and establishment of a 'national' financial system that was established through it, to which I now turn.

### 2.3 Forging monetary governance of the debt state

The growing national debt and increasing political tension between the landlords and merchant banks in England over who should bare the brunt of ensuring 'sound money' brought about enormous changes to the financial landscape in England. I argue that state established a more 'monetary' means of managing the national debt - focussed less on solvency - which was to lay the foundations for the Keynesian interventions that followed in the twentieth century. In this section I show how by the end of the nineteenth century a national financial system was established where the payments system revolved around a small number of clearing banks, with branches across the country, who accepted cheques from each other as a primary means of payment. What was not paid for by cheques was paid for in cash, of which the Bank of England was the sole provider (Chick, 1993). This meant that by the end of the nineteenth century clearing banks were dependent on the Bank for liquidity. This was liquidity that was secured on government debt, which meant that the newly forming monetary apparatus was entirely embroiled in the operation of debt management (*ibid.*). It is very difficult to grasp these developments from a perspective focussed on the power of creditors, instead they are better understood in terms of the effort to examine how the state as a debtor developed the capacity to manage its debts.

To reach this point, however, there first needed to exist a national system of payments, something that would give meaning to the very notion of a 'national financial system'. As such, I begin by examining how this national financial system emerged and what it meant for the way the state managed its debt. This involved the transformation of England's financial landscape, where the localised note-issuing country banks that underwrote eighteenth century industrialisation were



replaced in the nineteenth century by centralised, joint-stock clearing banks (Seabrooke, 2006) coordinated by the notes issued by the Bank of England. This left in place a highly politicised system of national financial governance that was subject to intense debate. By the start of the first world war, the monetary infrastructure constructed through public debt embedded public finance deeply into the workings of the broader economy. Through the twentieth century this became a basis for government to take an active role in economic governance, and especially in managing the problem that was to develop with Britain's external liabilities.

### Country banking and the industrial revolution

While the Financial Revolution and emergence of the first 'debt state' may have come from the London banking system, the Industrial Revolution in England was actually fuelled by the country banking system. These were banks that arose alongside, and directly supported, industrialisation and had intimate ties to industry, and they provide a different perspective on the nature of British finance to the London merchant banks that usually dominate readings of British economic history (for example Ingham, 1984; Anderson, 1964). The country banks played an important role in laying the foundations of a national system of finance on which the twentieth century forms of debt management were forged.

The country banks were born out of commercial or industrial ventures and were adapted to the needs of specific industries by drawing on the practice of discounting developed by the London Goldsmiths (Nevin and Davis, 1970) that I described earlier. As is well known, the manufacturing firms that emerged in the midlands and North of England did not rely on external finance. Instead their ventures were usually funded from family and social networks and their expansion was based on existing profits (Hall, 1986). This meant these industrialists had little need for the type of investment houses that supported, say, German industrialisation. Country banks were typically clustered around a particular industry or geographical region where these industries formed. These areas were often poorly served by the monetary system centred on mercantile exchanges in the City of London (Knafo, 2013). As the industrial revolution unfolded there emerged in England a uniquely dense network of domestic trade, distinct from the long-distance mercantilism that characterised British trade previously, and the continental economies of the time. For industrialists, the primary problem was less one of obtaining investment finance and much more an issue of finding means of

payment (Knafo, 2013 p. 114) for the domestic trade. This meant a different dynamic for financiers too. Instead of profiting through long-distance currency exchange and arbitrage, or financing domestic industrial investment, the main issue in supporting industrialisation was providing liquidity to facilitate this flourishing domestic trade. It was in this context that the country banks arose.

They were founded by already wealthy entrepreneurs in response to the need to provide local means of payment (Pressnell, 1956, p. 14). Country banking provided a solution through issuing banknotes secured against bills of exchange. The credibility of the banknotes was ensured because they were convertible into gold very soon after the bills of exchange had matured. As such note issues in this way allowed the money supply to increase quickly and easily with demand, but would not stay in the system, because the notes expired when the underlying assets matured. Discounting in this way meant country banks could provide liquidity to people whose financial assets were themselves not readily useable (Knafo, 2008).

The banking system of the time was, therefore, geared towards note-issuing. For the banks, this practice of discounting established an incentive to gain through lowering reserves as much as possible because the more notes were issued, the greater the profits. The only thing that needed to be managed was ensuring there was enough gold to meet maturing notes. This demanded a very close relationship with the industrialists to whom they issued notes, because the banks needed to be sure of the credibility of the assets the notes were issued against. This close relationship meant that country banks offered short-term credit too. The fact credit was provided on a short-term basis has since been taken as a sign of the speculative bias (for example Ingham, 1984; Hutton, 1996). But far from reflecting the separation of industry and finance, it was actually the demands of industrialists and their close relationship with financiers that ensured short-term credit availability (Knafo, 2008). Industrialists tended to finance more long-term capital expenditure from their existing savings, and drew in banks to for their liquidity needs, which made country banks' overdraft facilities ideal. Long-term needs, if they could not be met from in-house profits, were served by rolling and renewing short-term facilities (Newton, 1996). This demanded a much closer relationship between bankers and industrialists in Britain than the image painted by the caricatures of aloof London merchant financiers.

Country banks were small, locally-focussed and, because they were set up more to provide means of payment than provide investment finance, did not really need to chase greater deposits. As such they had no real interest in expanding through opening new branches. In this way the banking system was quite disjointed. In contrast to the fiscal apparatus of the state, which was more centralised and over which the state had clear control, monetary relations in England, even by the late eighteenth century were more haphazard. Indeed, the system of hundreds of different banks each issuing their own banknotes created a problem whereby it was difficult for any one bank to determine the quality of banknotes from any other (Knafo, 2013, p.115). As such banknotes were mostly issued for clients to use locally and banks were reluctant to issue to people who were not already their customers. Indeed, such was the closeness of their relationships that there was often a bias in credit allocation (Coterrell, 1980, p.211). Banks sometimes overlooked dubious bills of exchange and entered into informal arrangements with industrialists for the sole purpose of getting banknotes in return (Knafo, 2013, p. 139). Unsurprisingly, come the nineteenth century, there were repeated crises among the country banks stemming from over leverage that left them short of liquidity. The more widespread the use of notes became, the greater the potential danger of liquidity problems and banking crises. In one case, in 1825, one crisis led to the bankruptcy of 60 banks (Knafo 2013, p. 140), demonstrative of the fact that there was clearly a problem with the operation of country banks. Yet even at this stage country banks were quite isolated from each other and insulated from the wider economy as a whole.

As country banking grew with industrialisation, and notes became more widespread, however, the country banks began to become a crucial part of the discounting activities in the City of London. This brought the country banks and their regional bank notes into the same monetary sphere as the state's debt and as such country banking crises became a more significant problem for the state's monetary authorities (Knafo, 2013). Such potential for contagion never existed previously. The famous South Sea Bubble, for instance, despite its longstanding cultural legacy, did not actually undermine the broader financial system, indeed bankruptcy levels were barely affected by the crisis (Hoppit, 1986). Yet once the country banks had hooked into the London discount houses, this dynamic changed. Disparate parts of the nation's banking institutions were linked together, drawing the early contours of a more national banking system, with the potential for national

banking crises. The more frequent crises became and the more widespread their influence, the more their potential to pull the entire national economy down with them, and this presented a problem to policymakers. The more the national financial system could rise and fall together, the more important it became for the authorities to be able to foster stability (Knafo, 2013).

By the 1820s the Bank of England would be forced into taking greater control of the financial system precisely because of the way country banks became so vulnerable to crises. As a result, the liquidity of the payments system became the national issue we now know it to be. As Knafo (2013, p. 116) writes:

“As banking reinforced synergies between different economic regions (Hoppit 1986), the economy began displaying more regular business cycles. As the economy rose and fell together it foregrounded the issue of financial crises and liquidity and banking regulation became public issues with bank-note issuing a genuine public concern.”

The response from the Bank of England was to try to restrict banknote issuing in a way that targeted creditors, rather than suited them. Again this revolved around the pursuit of ‘sound money’. The landed aristocrats in parliament at the time had no faith in the ability of decentralised, private bodies to control the money supply adequately and as such wanted strong, central regulation. As rentiers, they were especially keen the value of the rents they charged not be dented by irresponsible and inflationary monetary manipulation from financiers using their discounting practices to inflate the money supply (Knafo, 2013). The move to restrict note issuing was clearly against the interests of industrialists, who relied on country banknotes for means of payments, but was also an attack on the financiers in London, who gained from discounting country banks bills. Yet it was still pushed through.

What this demonstrates is that in the construction of the financial order that existed at the time of Britain’s early indebted state, government did exercise power over some creditors. It is difficult to conceptualise these battles, policies and institutional linkages from a perspective on debt politics that lines creditors up against debtors, and assumed the former’s ‘market power’ can explain political economic developments. What is instead revealed is how political struggles around credit and debt are articulated and fought through more concrete social groups with more immediate interests. Moreover, in the case of the demise of the country banks, it is revealed how ‘sound money’ was pursued by the state targeting a key

group of creditors. I now turn to the new linkages that formed through the demise of the country banks by switching my focus to the newly forming joint-stock banks.

The emergence of joint-stock banks and a national financial system

The key task facing the monetary authorities was regulating the supply and quality of banknote issues. To this end the Bank of England targeted the country banks, by imposing ceilings on their note issues and actively supporting the rival joint-stock banks that were emerging during the first few decades of the nineteenth century (Collins, 1988). These were banks that relied on deposits rather than note issuing for business and the authorities supported their development by granting them various privileges, most significant of which was limited liability. The success of the joint-stock banks, cultivated as it was by the state (Seabrooke, 2006, p. 58), came at a direct expense to the country banks, who were quietly suffocated out of existence. Though in 1880 there were still 157 note-issuing banks in England and Wales, issuing over £6 million of banknotes, they were easily overtaken by the big joint-stock banks which appeared in the nineteenth century (Knafo, 2013, p. 142). As country bank financial provision subsided, the right to issue banknotes was granted solely to the Bank of England. This laid the foundations for modern central banking and monetary policy management (Knafo, 2013). In what follows I describe how the significance of this was to loosen the tie between the various means of payments (money) and central bank (gold) reserves even further, and solidify a 'national' payments system while also creating a new role for national debt securities.

The joint-stock banks dominated the late nineteenth and early twentieth century and remain familiar high street names even today<sup>4</sup>. These banks became the dominant supplier of credit in the market and, towards the end of the nineteenth century, were pulled more into the orbit of the London financiers (Seabrooke, 2006). The character of the British financial system as we now know it – commercial, speculative, and highly concentrated – can be traced back to the later development of the joint-stock banks in England. Their emergence also helped establish the Bank of England at the apex of the emerging national financial system because it was the sole provider of cash. The Bank was happy to see the clearers

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<sup>4</sup> Though they have undergone mergers, banks like Barclays and National Westminster remain high street names.

grow and develop wide branch networks of customer deposits because of its belief that greater capitalisation would help shore-up the financial system that had suffered repeated crises and would lessen its dependence on the London financiers (Seabrooke, 2006). The Bank of England looked at the Scottish example of joint-stock banks, with their bigger deposit base, and saw a stability lacking in the old English country banking system. As such the monetary authorities licensed the creation of joint-stock banks in London (on the condition they did not issue notes) which allowed them to tap into the vast resources of the City. England's financial system was being tilted away from banknote-issuing country banks and towards deposit-taking joint-stock banks.

The rise of joint-stock banks set up a new dynamic in the financial system which multiplied liquidity. The country banking system relied on discounting gold reserves and increasing liquidity by issuing notes. Yet the joint-stock banking system worked by clearing banks issuing cheques drawn against deposits, as a means of payment (Chick, 1993). It created an extra layer between the broad money supply, the stock of Bank of England notes, and the country's gold reserves. Simply, claims on deposits could now act as means of payment. The clearing banks could increase loans by issuing cheques, something that did not require new note issues by the Bank of England, or an increase in gold reserves. Cheques had not really developed as a system of payment in continental countries (Hughes, 2016) and set up in Britain a fundamentally different financial trajectory. Joint-stock banking in this way helped to decouple money from gold, and instead made public debt securities - banknotes and other short-term public securities - the monetary base of the payments system (Chick, 1993).

Within clearing banks themselves, the incentive was to branch out so as to deepen the pool of deposits. This is reflected in the growth in deposits from £9m to £43m between 1844 and 1857 and a vast expansion in the number of bank branches (Nevin and Davis, 1970). The effect on liquidity was vast and meant that lending could be extended as long as the clearing banks felt able to obtain liquid liabilities. This was helped by a developing practice of commercial banks lending to each other. This was done in large part in Britain through what were known as discount houses. The importance of this was again in facilitating a great expansion of liquidity without having to obtain more commodity money, gold. The growing use of cheques as a means of payment, interbank lending through the discount houses, and the resultant distancing of the payments system from gold, necessarily involved

an intellectual transformation in how money and the financial system were perceived. Firstly, the notion of money as a commodity, which underpinned the sound money focus on limiting the minting of coins, had grown outdated. By this stage and there was instead more emphasis on money as an intermediary, a means of payment (Chick, 1993).

In terms of the governance and the pursuit of sound money this meant a change in strategy for the monetary authorities. With a national payments system increasingly removed from commodity money, the goal of limiting inflation took a different form. The authorities had to ensure that bank notes were not over issued. This was in part achieved by curtailing country banks from issuing notes, and crucially by trying to tie the hands of the Bank of England through an imposition the gold standard (Knafo, 2013). Not only did this limit the ability of the Bank to create liquidity but, with the carefully cultivated emergence of the joint-stock banks, meant there was an ability to control credit creation more generally. The clearing, joint-stock banks created liquidity through cheques and cash. They could originate cheques, but the Bank was the sole provider of the fraction of means of payments that was not made through drawing on cheques: cash. As such when the clearing banks needed access to cash they had to borrow it from the interbank market - cleared through the discount houses - who in turn were dependent ultimately on the sole supplier of cash, the Bank of England (Collins, 1988).

The more the clearing banks extended their branch network, the more liabilities they had to manage. There was a tension here. Because the banks did not want to store excessive amounts of cash deposits - on which they received no interest - they wanted to invest some of these. At the same time, they needed to be sure they had sufficient cash reserves to meet any sudden surge of customer demand for cash. So this delicate management of liquidity was the responsibility of the joint-stock banks (Nevin and Davis, 1970). But the way they balanced these twin imperatives was through the discount houses. They put a proportion of their deposits in discount houses - which were short-term loans on which they earned a slim return - but were easily retrievable (Collins and Baker, 2001). If any bank needed to fund a sudden surge in cash demands, they could then borrow liquidity from the discount houses (at a slim cost), and that way the payments system could operate securely. If, however, there was a systemic withdrawal and the discount houses were short of cash, they could go to the Bank of England (Allen, 2014). This was the hook between the Bank of England and the national financial system. The

Bank set the rate at which they lent cash to the discount houses, and therefore the clearing banks, which was called the Bank Rate. The terms by which the Bank provided funding to the discount houses had an effect, therefore, on the entire financial system.

#### National debt in the national financial system

At this point it is worth outlining just what had happened to the debt in the years between the establishment of the Bank of England and the end of the nineteenth century. The Financial Revolution had granted the state a capacity to issue its debt as money. Nonetheless until the nineteenth century the national debt could primarily be thought of as part of the fiscal-military state as described by Brewer (1990), with the state's debt management a fiscally-driven operation. War had made the parts of the debt seemingly immovable while peacetime generally slowed its expansion, but did not foster significant reduction the principle total. The Napoleonic wars between 1803 and 1815 substantially increased the debt from £324 million to £834 million (Hicks, 1954, p. 174) and secured England's dominant position in Europe (Braudel, 1982). This was financed in the usual way, with the state issuing gilt-like securities through the Bank of England to London merchant banks, the colonial banks, and by the Bank of England's Means and Ways advances (Hicks, 1954). By this point, however, as I outlined above, the national debt was beginning to have a crucial impact on the broader economy. This was because advances counted as an asset that backed note issuance, so the more that the government borrowed in this way, the more notes the Bank of England was able to bring into circulation. The notes themselves were as source of greater liquidity but these effects were multiplied because of the way cheques could be drawn against them, and used as a means of payment within the clearing bank network (Werner, 2015). In that sense, the moneyiness of public debt was being steadily embedded into the deeper workings of the economy as a whole.

The Bank of England was very happy to keep expanding note issues, but this ran up against the belief that the ever increasing gap between gold reserves and the money supply risked inflation and needed to be closed. As such 1821 saw the imposition of the formal gold standard (Knafo, 2013). This was driven by the desire of landlords to restrict note issuing by the Bank of England (and the declining country banks) and - contrary to the common assumption of indebted state being dictated to by its creditors - thereby ensured that the London bankers who had



been financing the state gained no further power, and blocked the possibility of inflation damaging the rents landlords received. The financial sector, as such, was deeply opposed to the imposition of a Gold Standard (ibid.). The fact it was driven through set up a particular problem for the monetary authorities who needed to be sure that there was enough gold at any time to meet any surge for convertibility. This set up a mercantilist like imperative to amass gold and demanded an especially extractive monetary arrangement from the colonies. The traditional accounts of the impact of British finance and empire sees the Gold Standard as helping attract capital from abroad by ensuring stability that made the use of sterling attractive. The reality was more that the imposition on the Bank of England to ensure convertibility meant that colonial countries were bled of their gold:

“In the early 19th century, the Bank of England in times of difficulty would enquire of the East India Company as to know whether there were significant treasures in bullion heading towards England (Clapham 1958). To exploit this source more readily, monetary relations with India were increasingly formalized so as to draw out gold bullion and respond to the new imperatives of banknote issue convertible into gold” (Knafo, 2005, p. 269).

While the value of gold was high in Britain it made sense for gold to be sent there, and the gold standard was supported by appropriation of gold in the colonies which, given the Bank of England's influence over the gold market, could then feed the expansion in banknote issuance domestically. In this sense monetary policy in the mid 1800s was largely an international affair, all about maintaining the external value of the currency and an international monetary order based on sterling, which meant ensuring sterling did not inflate (Chick 1990, p. 85). At this stage it meant in practice little active intervention domestically by the Bank of England, just a general nod to the flows of gold in and out of London (Tomlinson, 1985, p. 32). The rate of interest was directed towards managing the external value of sterling, while banks were largely left to themselves to manage their liquidity.

This, however, began to change when the use of the Gold Standard spread to European countries in the late nineteenth century. European countries switched away from a silver or bimetallic standard to gold instead, and established a regime of fixed exchange rates between countries (Knafo, 2013). This provided an opportunity for financiers to arbitrage between countries and in doing so put pressure on central banks to amass reserves to meet these attacks. In this way the contours of the twentieth century balance of payments issues were being drawn,

with central banks in the middle of the dilemma. In the late nineteenth century Britain's solution to the problem of maintaining convertibility was to further bleed the colonies. Forced trade with India, paid for not in products but in gold, ensured the British gold standard was supported through colonial exploitation (ibid.).

Though it is often viewed as a restrictive form of monetary governance - limiting the state's room for manoeuvre - the Gold Standard did little to inhibit the growth of public debt. Peace in Europe for the remainder of the nineteenth century allowed the level of the debt to drop slightly, along with Gladstone and the Victorian sensibility against excessive debt which saw the state pursue regular budget surpluses (Hicks, 1954). Nonetheless the debt-liquidity dynamic I described above was dramatically extended in 1877 with the invention of the Treasury Bill (ibid.). The Treasury Bill gave the state greater capacity for government to borrow from the financial system while at the same time solidifying the internal links between the state's management of liquidity in the financial system and its operation in government debt management. In this way it was another crucial aspect of national debt that linked different monetary institutions together and helped build the capacity of the state to empower itself through public debt.

The Treasury Bill was well suited to the apparatus of the London money market. Until then it was commercial bills - bills of exchange - that were the dominant means of short-term lending to finance international trade, and the main repository of commercial banks for their short-term funds, and the stock in trade of the discount houses (Hicks, 1954, p. 179). The Treasury Bill did all of these things, but - backed as it was by government - with substantially less risk. Moreover, Treasury Bills provided discount houses with a new source of liquidity. Previously, to borrow cash from the Bank of England, discount houses needed the collateral of high quality commercial bills of exchange. These were obviously in quite limited supply, especially during times of economic downturn. Yet the arrival of Treasury Bills not only provided an alternative form of collateral but also a discount house could hold them too maturity and collect the cash payout.

As I will discuss in the third chapter this was to become a major issue after the second world war when the use of Treasury Bill financing had really swelled. Nonetheless for now, in part due to the austere Gladstonian principles of public finance described earlier, and the lack of expensive wars to fight in Europe, the new Treasury Bills were barely issued, except as a form of bridging loan before tax revenues came in. Even as late as 1914 there were just £13 million worth of

Treasury Bills compared to an estimated £500 million supply of commercial bills (Hicks, 1954, p. 180). The national debt, on the eve of the first world war, stood at its lowest ever level of 27 per cent of GDP (Goodhart, 1999, p. 44). However, the growing complication of monetary policy was to become entirely embroiled in debt management by the massive expansion in Treasury Bills used to finance the debt-binge that was the two world wars.

#### 2.4 The first world war and the foundation of Keynesian intervention

The national debt had long been embroiled in the military adventures of the state. The Bank of England was founded on war finance and it was debt that sponsored Britain's colonial brutality for the following three hundred years. The relative (European) calm of the nineteenth century was exploded by the first world war and its cost necessitated a fundamental shift in the balance between public and private participation in financial markets (Hudson, 2003). The huge expansion in public debt, when allied to the developing national banking infrastructure, translated into a concentration of power within the Bank of England that ended up laying the foundations for the Keynesian revolution that followed. Britain's debt state was remade through the war through the creation of number of internal institutional links between the state, the banking system and the broader economy.

The increase in debt through the war was substantial. Government short-term borrowing was £16 million in August 1914 and £1.5 billion by November 1918, most of which came from the clearing banks (Michie, 2004, p. 254). By 1919 lending by banks to private customers had fallen to half its pre-war level - 32 per cent of available funds - with loans to government forming the majority of bank investment (*ibid.*). It meant that by the 1920s the relationship between the Treasury and the Bank that had developed through the war was necessarily very close. The Bank held government accounts and acted as the agent of the Treasury and gave advice on monetary policy. The Treasury, meanwhile, managed public debt while the Bank oversaw the money market (Green, 1991, p. 205). Clearing banks that had been primarily private-sector intermediaries before the war substantially increased their holdings of government securities (both short-term Treasury bills and longer-dated gilts) at the same time as the private sector contracted (Nevin and Davis, 1970).

The nature of commercial banking also shifted in a way that provided for the state as a debtor another avenue (via the Treasury and Bank of England) through

which to influence the economy. There was a decline in the use of specie during the war, which meant paper money was quickly becoming the most common means of payment for everyday purchases (Chick, 1993). Accordingly, people expanded their use of current accounts where money could be withdrawn easily and quickly for everyday payments. This, in turn, made it more important for clearing banks to watch their deposit liabilities carefully, because mass use of notes meant made customers more willing to take out money at any one time. The reserve ratio - between deposits and cash liabilities - became an important figure that indicated to the public the credibility of individual banks, and to the government the stability of the broader financial system (Collins, 1988, p. 238). The political importance of these reserve ratios was reflected in the fact that after the Barings crisis in 1890 chancellor George Goschen and Robert Palgrave led a campaign about banking stability centred on a call for liquidity (Nevin and Davis, 1970, p. 137). The actual utility of the reserve ratio figure to managing liquidity is in fact rather questionable. Many bankers of the time argued it was only one of a number of things they watched. The Bank of England, for example, also looked at specific markets - the like discount markets or gold losses - as indicators of wider economic trends (Moggridge, 1972, p. 146). In addition to these quantitative values, they also gleaned information from partners and contacts within the City. Nonetheless, the fact that the reserve ratio figure itself was publicly debated, with politicians wading in with recommendations of the "correct" ratio, demonstrates that the governance apparatus that had emerged through the nineteenth century had matured sufficiently to be a point of real political significance (Michie, 2004).

The ratio of reserve capital to liabilities fell as banks sought greater profits. It had stood around 12-14 per cent in the 1890s, 10 per cent just before the first world war, 6-7 per cent during the war, and it remained around that figure thereafter (Collins, 1988, p. 237). This cash ratio became more and more important as bookkeeping methods improved and regular public statements about clearing banks' cash position was made both possible and necessary (Nevin & Davis: 1970: 137). The importance of these aggregates was reflected by the parliamentary Macmillan committee on finance and industry (1931). It argued that a fixed ratio was needed to ensure the Bank of England's control over money markets (Macmillan committee, 1931, p. 12). The total cash position of the clearing banks was an important aggregate from the point of view of the Bank of England, who took it as an indicator of monetary wellbeing in the economy (*ibid.*). It is worth

remembering that a century before, such aggregates - and the Bank's place in controlling them - could scarcely have been imagined. That it existed now was in large part due to the machinations of the debt state that had evolved over the previous centuries. The Macmillan report cited the fact that Britain lacked the legal requirement on a fixed ratio of deposits to liabilities that existed in the US, something the report argued, undermined the monetary authorities' ability to ensure stability (Nevin and Davis, 1970, p. 137). This was because of the relationship between central bank money - secured on government debt - and the broader monetary system. The report argued that if the liquidity ratio was rigid, changes in the money supply of cash to the discount markets made by the Bank of England would show quickly in the change in level of commercial bank receipts and banks would be obliged to alter their loans and investments in order to re-establish the desired ratio. In that sense a fixed ratio meant the Bank could manipulate commercial bank lending more quickly and effectively (Collins, 1988, p. 241). It was in this way that monetary dynamics became such a crucial part of the 1930s debt state in Britain domestically.

Alongside the significant expansion of war debts to the domestic monetary system the first world war entailed the first example of direct intergovernmental debt. Previously the state had raised finance from the private sector, to be repaid, in theory, by expanding domestic productivity, and collecting the tax receipts that resulted, and repaying creditors. This changed during the first world war as Britain especially racked up enormous "external liabilities" by borrowing from foreign governments, and one government in particular: America (Cairncross, 1991). This created a new dimension to the debt state. As Keynes wrote in his *Treatise on Money* "war concentrated gold in the vaults of the Central Banks; and these banks have not released it" (Keynes 1930, p.291). The dynamic where central banks had to amass reserves in order to protect their currencies took on a new dimension. Britain had used its colonial position to be a creditor to the world but the vast expansion of debt needed to fight the first world war meant this situation reversed. The difficulties it had had sustaining itself during the internationalisation of the gold standard after the 1870s was magnified as it was forced to borrow from America. In order to finance the war effort Britain suspended the promise of convertibility into gold and instead afterwards tried to establish a relationship to the US dollar. Having borrowed so much from America it faced the issue of amassing dollars (Schenk, 2010). Arms sales were bought 'on credit' to the American Treasury and as such

after the war Britain had to find ways of amassing dollars to repay the debt. This was to become an enduring problem for the next fifty years. Initially, India came of use once more. Forced trade, this time paid for in dollars, worsened India's own balance of payments but helped Britain with the resources to finance its external liabilities (Knafo, 2013, p. 170).

This meant that by the end of the first world war there were three aspects to the activities of the Bank of England: primarily, it still had the responsibility for raising loans for the state. Attached to this it had a role in managing liquidity of the domestic economy and ensuring that note issuance didn't lead to inflation. Finally, it had a problem of ensuring sterling notes could easily be converted into dollars. The national debt had evolved from its 1600s origins in such a way that by the 1930s the Bank of England was absolutely pivotal to the politics of the country. Moreover, the Bank operated through a new imaginary of metrics that did not exist when it was first founded. It was in control of a national banking system, a national currency, there were aggregate estimates of deposits, of reserves, of ratios, and a national balance of payments account. These were all aggregates that rose and fell on something resembling a national economic cycle and the Bank of England had the capacity to affect all, and in that way was in the process of crafting linkages between the central state as a debtor and the broader national economy that came to radically empower the central state in the decades that followed.

What was missing at this stage was a clarity over the precise nature of the relationship between the Bank Rate and the broader effects domestically and internationally. There was a well-established tradition, starting with the landowners of the seventeenth century, to control credit creation by controlling the quantity of money minted so as to deflate the economy. Yet it was increasingly clear that in the debt state that was taking shape credit creation was seemingly more distant from the commodity money base, and as a result, it was possible to use monetary interventions into the economy (through the Bank Rate) to shape the interest rate at which debt financed is raised. It is in this context that we should read the rise of Keynesian ideas on money, debt and interest which I turn to in the following chapter.

## Conclusion

The capacity to finance itself through the issue of banknotes was something unique to the British state. The fact that its debts could circulate as money since the

Financial Revolution meant the levels of debt it could raise grew well past that which could be realistically repaid. Though the monetary authorities in Britain tried repeatedly to develop fiscal policies that would contain and repay the debt, these soon became the basis for yet more borrowing. In taking the long view on the relationship between the British state and its debts, and tracking how public debt acquired monetary features, it became clear how these features compelled a number of regulatory reforms to British finance. The country banks had to be suffocated out of existence, and the Bank of England established as the central provider of liquidity to the economy as a whole. It meant that by the end of the nineteenth century government debt had ceased to be a mere means to finance fiscal expenditure, but was implicated in the workings of the national economy as a whole. This apparatus, in turn, was changed by the first world war which resulted in a huge expansion in Treasury Bill-financed, short-term government debt and the emergence of inter-governmental debt. The political economy of this context cannot be understood simply as creditor power: the clearing banks that financed much of the state's debts through their Treasury Bill holdings were not dictating terms to government. If anything, it was the central government - through the Bank of England - that had the potential to affect the broader economy. The steady institutionalisation of public debt as a form of money meant an increasing politicisation of the terms by which government managed its debts. The Bank of England was the lynchpin of the financial system, making the Bank Rate a highly contentious issue by the end of the first world war. Moreover, the ability of the state to use its debts to inject liquidity into the financial system and broader economy was something that would soon be harnessed for Keynesian style governance.

In outlining this longer history to the British debt state, this chapter provides the backdrop for the thesis's contribution in reconceptualising the relationship between the state and public debt by showing how the moneyiness of public debt allowed the British state to sustain increasingly large volumes of debt. I have outlined some of the internal linkages between the state and the broader economy that were established through debt financing, linkages that are not easily accounted for when debt financing is seen as a near automatic response to insufficient tax revenues or driven simply by overexploitation of the 'common pool' of public finances as in the classical political economy imaginary. From this grounding, in the chapters that follow I develop an alternative perspective on the Keynesian state that emerged, showing how it represented an acknowledgement of the capacity built in

the centuries before for using the national debt as a tool of economic governance in a way that had not happened previously.



### 3. The making of the Keynesian debt state

#### Introduction

The question of public debt was transformed by Keynes. He broke with the orthodoxy that preceded him to argue that, if used correctly, public debt finance could pay for itself, and grow the common pool of a nation's economy. Far from a poison to avoid, debt was a tool to be used. The significance of this shift is well recognised in the way Keynes's name is so readily associated with debt. This is apparent in the discussions of the military Keynesianism of Cold War America (for example Griffin et al., 1982), or the asset price Keynesianism of contemporary America (Brenner, 2007), and privatised Keynesianism in Britain today (Crouch, 2009). Which are each united through their general dependence on debt-based growth.

Yet despite the focus on the importance of debt to Keynesianism, the monetary aspect of Keynes's thinking is often overlooked. This is especially so in the debate over whether there was ever a 'Keynesian revolution' in British economic policymaking (Tomlinson, 1981; Booth, 1984; Booth, 1985; Tomlinson, 1984; Clarke, 1998). The debate is framed as a conflict between Keynes and the orthodox 'Treasury View' that surrounded him (Peden, 1984; Booth, 1985). This battle centred on Keynes's idea to use debt-financed fiscal spending to guard against recession, instead of the traditional Treasury preference for balanced budgets (Peden, 1984). Precisely because the monetary aspect of public debt is occluded, the Keynesian revolution is framed in fiscal terms.

In this chapter I recast the Keynesian revolution in Britain. I show that the importance of Keynes's thinking was to embrace the moneyiness of debt and transform economic policymaking in Britain by making public debt securities a basis for the state to manage system wide macroeconomic liquidity. In that sense I show how Keynes's intellectual thought and the apparatus of Keynesian governance came out of the monetary infrastructure that had developed in Britain since the Financial Revolution. By the time Keynes came to dominate economic policymaking in Britain, during and after the second world war, the state had amassed a huge

national debt (Nield, 2012), and for the first time was a debtor rather than creditor to the global economy (Schenk, 2010, p. 54). As such management of the national debt had become a central part of economic policy, providing challenges and opportunities that were unique to Britain and its financial system that had developed in the two centuries before.

I argue that Keynes's impact on economic governance can be better understood by reassessing the supposed rift with the Treasury View. These were not diametrically opposed positions, rather Keynes shared much with the key author of the Treasury View, Ralph Hawtrey. Hawtrey was the intellectual force behind the Treasury (Peden, 1984, p. 168; Howson and Winch, 1977) and was concerned primarily with monetary, rather than fiscal governance (Hawtrey, 1919; Hawtrey, 1926; Mehrling, 2010). I join monetary Keynesians like Geoff Tily (2010) and Ann Pettifor (2014) in arguing that Keynes's influence on economic governance in Britain is better cast in terms of his monetary thought, rather than the fiscal caricatures by which his influence is now often defined. This puts the Keynesian state and its use of public debt in a new light. The state did not simply use public debt as a means to finance counter-cyclical fiscal spending - the classic notion of Keynesianism - but precisely because of the monetary infrastructure that had been constructed over previous years, debt could be a tool for wider economic governance.

The chapter proceeds broadly chronologically, covering the period from Clement Attlee's postwar Labour government in 1945, to Harold Wilson's devaluation of Sterling in 1967, an era often referred to as 'the Keynesian consensus' (Kerr, 2001). In keeping with the chronology, I make four arguments over four sections. First I examine more deeply what is meant by 'Keynesianism' and the assessment of the Keynesian revolution in Britain. Here I show how Keynes was very much a successor, rather than opponent of Hawtrey and the Treasury View. Thereafter I examine how Keynes's ideas were translated into practice and what institutional infrastructure was necessary to construct the Keynesian state. The second section argues that a key Keynesian influence on Attlee's postwar governance was the use of short-term government debt securities - Treasury Bills specifically - to borrow directly from the banking sector so as to increase liquidity and keep public interest payments low. This period of 'cheap money' had profound consequences on the years that followed. In the third section I argue that a key impact of 'cheap money' was to render monetary policy

ineffective at controlling the domestic economy. As such economic governance had to take place through budgetary means. To do so effectively meant developing further the tools of national accounting and macroeconomic indicators, and place the Treasury at the centre of economic life. This empowered the Treasury in a way that it had never enjoyed previously. Finally, in the forth section I describe how the controls on the clearing bank sector intermeshed with the needs for financing the public debt, and made government spending the key lever of monetary control.

### 3.1 **Was there ever a ‘Keynesian revolution’ in Britain?**

On June 1 1944 William Beveridge launched the White Paper on Full Employment that committed the government to deliver employment to all British citizens of working age. It was a document that turned the economic theories and moral commitments developed by Keynes over the previous two decades into political orthodoxy. The government would no longer be a neutral observer of economic life, it was to become the key protagonist, marking the start of what is considered to be nearly three decades of the ‘Keynesian consensus’ (Crouch, 1979; Brittan, 1971; Winch, 1970).

Commentators like Peter Kerr (2001) have since come to define Keynesian governance as containing elements as diverse as a ‘mixed economy’, with nationalised companies, and a nationalised central bank, progressive taxation, a welfare state, and most centrally of all, the use of counter-cyclical demand management - usually through government spending - to iron out creases in the business cycle and ensure full employment. Entailed in this is a broader social reading of Keynesianism as a period of a ‘compromise’ between the interests of capital and the growing power of organised labour, brokered by the state (Clarke, 1988).

In Britain, assessment over the extent to which this Keynesian regime took hold is examined in terms of how far postwar policymakers departed from the Treasury View of ‘balanced budgets’ and ‘sound money’ that was previously the supposed orthodoxy (Booth, 1984). The importance placed in the Treasury View is bound up with the imaginary of Britain as an iconic liberal state where government refrained from intervention into private economic life as far as possible (Kerr, 2001, p. 56). It is why Keynesianism is supposed to somehow represent a departure from a liberal ideal (Cronin, 1991, p. 12).

In what follows I demonstrate that the debate on whether there was ever a Keynesian revolution in Britain is forged on opposing Keynesianism to the Treasury View, and questioning how far Keynes forced a departure. It is my contention that this opposition is misleading. By focussing on the differing fiscal implications of Keynesian thought compared with the Treasury View, this debate has negated how both the Treasury View and Keynes's critique of it can alternatively be considered as monetary policy programmes - rather than fiscal - and shared much more in common than is often acknowledged. Moreover, examined in these monetary terms it becomes possible to see how the Keynesian revolution in Britain implied a broader role for the way public debt securities were used for governance than is often given credence to in the caricatures of Keynesianism as expansionary fiscal governance.

This tends to get overlooked in the debate about the British Keynesian revolution. For example Kenneth Booth (1984; 1985) is one economic historian who insists that Keynes did revolutionise British economic policymaking. Building on the archival work of Howson and Winch (1977), Booth outlined how Keynes gradually won over officials in the Treasury to establish Keynesian analysis as the "dominant discourse in policy-making" (1984, p. 263). This involved persuading the Treasury that their classical assumptions about the nature of the market economy were wrong and that there was a place for state-led macroeconomic solutions to unemployment: including deficit spending, capital spending, public works programmes and monetary policy adjustments. Though Booth mentions monetary policy, the main focus of his work is tracing out Keynes's influence on Treasury attitudes to unemployment and his advocacy for state management of the economy by making "state administrators see the government budget not simply as a statement of public finance, but as an instrument to regulate the whole of domestic expenditure so as to avoid, or at least control, inflationary pressures" (1983, p. 107). Broadly this revolved on Keynes's attempt to demonstrate to policymakers that in a market economy production was limited not by resources and productivity, but, ultimately by demand, and as such, if demand could be managed centrally, full employment could be reached. This meant using fiscal demand management to fix unemployment, something that necessarily meant a departure from the 'Treasury View' orthodoxy of balanced budgets (Peden, 1984).

Keynes's theoretical insight marked a radical shift in the minds of policymakers that previously, as the interwar period of crisis and recession

supposedly proved, had been bound by the Treasury View that was notionally critical of all government spending. By Booth's reckoning Keynes made some headway trying to adapt the Treasury's attitude to the budget during the second world war, but presented his arguments in terms of the unique demands of wartime conditions which meant there remained no general official acceptance of Keynesian ideas (Booth, 1983, p. 107). By 1947, Booth argues, Keynesian thinking had established itself as the Labour government switched from wartime planning of the economy to more generalised demand management (*ibid.*, p. 121).

When posed in this way, the Keynesian revolution is a revolution of ideas, rather than institutions *per se*. The belief in the efficacy of counter-cyclical spending and the disgust of unemployment gradually became a norm that guided postwar policymaking. In this account the significance of Keynes can be derived from policymakers' commitment to the use of budgetary spending to counter unemployment (Booth, 1984). When, in the mid 1970s, the consensus appeared to turn against counter-cyclical spending, the apparently short-lived nature of this ideological shift forced many to question whether there really had been a meaningful departure from the old orthodoxy. Many, (for example Tomlinson, 1981; Kerr, 2001; Green, 2013; Seymour, 2016) depict Keynesianism as a "still birth", a brief moment (from 1941-1955) when policymakers departed from the Treasury View and backed the potential of fiscal demand management. Keynesianism was undermined, and then strangled entirely by a return to the "balance-budgets orthodoxy" (Green, 2013, p. 78) soon after.

This has implications for the way the literature conceptualises the role of public debt in Keynesian governance. A move away from the orthodoxy is supposed to entail a move towards an active use of debt to finance counter-cyclical fiscal spending (Tomlinson, 1981). That this shift proved so momentary is taken as proof that creditor and financial interests choked off any hope of a lasting Keynesian revolution. Geoffrey Ingham (1984) sees in this the power of the City-Bank-Treasury nexus, while others identify the dominance of Gentlemanly Capitalism (Cain and Hopkins, 1993) or pre-modern, aristocratic political economic forms (Anderson, 1964; Nairn, 1977). No matter the theoretical inflection, the point remains the same: British Keynesianism was sacrificed at the altar of finance.

Yet as I stated all this stems from a reading of Keynes in terms of his opposition to the Treasury View and a belief that Keynesianism is ultimately a matter of debt-financed counter cyclical fiscal spending on public works. It is my

contention that the difference between Keynes and the Treasury View has been exaggerated by scholars who assess Keynes in overly normative terms. Instead it is important to contextualise Keynes within his intellectual interlocutors, especially in the battle he was fighting with the 'Treasury View'. Ralph Hawtrey is the key theoretical architect of the "Treasury View" (Howson and Winch, 1977, p. 27) and was Keynes's friend at first Cambridge and later the Treasury (Clarke, 2009, p. 120), and is a key foil for Keynes's ideas. Hawtrey was a monetary economist, belonging to a rich tradition in Britain of monetary thinking<sup>5</sup> that first coalesced in the nineteenth century around the issue of the lender of last resort, and the Bank of England's place at the centre of the monetary system (Creedy and O'Brien, 1984, p. 21). Hawtrey's concern with balanced budgets and 'dear money' came from a theory about the inherent instability of credit. Hawtrey argued that credit had a natural propensity to increase, fuel inflation, and then rapidly decrease leaving deflationary chaos in its wake (Mehrling, 2010). The broader tradition of monetary thinking in Britain - from William Thornton through to Walter Bagehot and then Hawtrey - was highly sceptical about the ability of 'the market' to self-regulate money, and outlined the need for active, centralised governance through the central bank. This built on Bagehot's recognition that the financial system that had developed through discounting, and then the emergence of a national banking system orientated around the Bank of England, demanded that the central bank take an active role in restricting credit creation (Mattei, 2016). To curtail what he deemed the inherent drive for credit expansion he advocated 'dear money': a high Bank Rate to restrict private sector borrowing, and balanced budgets so that private banks would not see their assets swollen by 'unfunded' national debt in the form of Treasury bills and similar securities (Mattei, 2016, p. 16).

It is as part of this broader theoretical apparatus - founded on the idea that liquidity should be governed - that Hawtrey made his (and as such the Treasury's) case against the efficacy of Keynes's 'public works' solution to unemployment in the 1930s (ibid.). Simply, Hawtrey felt that credit was the key driver of economic activity, so any increase in credit would bring an immediate stimulus to economic activity and would work to combat unemployment. If public works were funded by

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<sup>5</sup> Hawtrey can be said to have built on the tradition of Bagehot and the broader Banking School, which traces its early articulation to William Thornton's demand for the Bank of England to act both as a lender of last resort but more importantly as a manager of the banking system through active, discretionary monetary policy.

the government competing on private sector credit markets for investment funds (a debt funded by savings) then it would crowd out private uses of credit. If, however, public works are funded from bank credit then yes, this would act as a stimulus, but a stimulus caused by the increase in bank credit, irrespective of its use in the building of public works (ibid.).

Part of Keynes's theoretical innovations stemmed from participating in this conversation about monetary dynamics. Keynes had developed ideas about the liquidity preference in his 1930 *Treatise on Money*, which fed into the *General Theory* (Moggridge and Howson, 1974) and in the discussions that followed the publication of the *Treatise* he advocated for the use of monetary management to try and pull the country out of recession. "A reduction of the long-term rate of interest to a low level is probably the most necessary of all measures if we are to escape from the slump and secure a lasting revival of enterprise," wrote Keynes in the midst of the Great Recession (1932, p. 415). He saw the Treasury as key to this goal, arguing that "the market should be supplied with securities of different types and maturities in the proportions in which it prefers them... Indeed, it must always be to the interest of the Treasury to supply the heterogeneous requirements of the market with securities of different types and maturities in the optimum proportion" (1932, p. 416).

Keynes (1978, p.337) had identified "the high level of market interest rate" as the "most striking change" in the economic conditions that characterised the pre-war to post first world war economy, and could best explain the depth of the recession that surrounded him. As such he advocated for low interest rates as a solution. His contemporary, and later biographer, Sir Roy Harrod (1983, p. 469) wrote later that by the 1930s Keynes "had become convinced that the time was ripe for a large and permanent reduction [of interest rates] throughout the world. This was to be the basis of all his future thinking on economic policy."

In that sense, though the 'fiscal Keynes' dominates popular imagination, he can also be thought of as following Hawtrey as the latest in the tradition of British monetary thinkers, and in particular sharing Hawtrey's interventionist approach to monetary policy (Moggridge and Howson, 1974, p. 232). In respect to this he wrote to Hawtrey in 1930, "I feel that ultimately I am joined in common agreement with you as against most of the rest of the world" (in ibid.). This focus is lost because Keynes's political advocacy against unemployment, and the possibility of fiscal injections through public works programmes, dominate impressions of Keynes's

thinking. But public works were only ever a very narrow part of Keynes's programme for governance, to be used only to jump-start an economy out of depression, rather than as a basis for demand management (Tily, 2010).

Where Keynes differed from Hawtrey was in his attitude to liquidity. Hawtrey saw credit as inherently expansive and in need of restrictive governance. Keynes veered in the opposite direction and argued that people had a liquidity preference - a desire to hold onto cash - because of the inherent uncertainty about the future (Tily, 2010, p. 186). As Keynes famously wrote, the "desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future ... The possession of actual money lulls our disquietude" (Keynes, 1987, pp. 116–17). His argument was that people want to mitigate the risk of changes in the availability of future liquidity. This is where the Bank Rate is so crucial because it sets the price of cash (liquidity today). If people expect rates to rise then the price of bonds will fall and speculators will choose to hold their wealth as cash. If they expect rates to fall they will prefer to hold their wealth as bonds. In that way the demand for cash (liquidity) changes according to expectations of future rates (Tily, 2010, p. 188). If the normal rate of interest is set very low then there is very little reason to hold inactive, speculative money and this wealth would instead be held as bonds. Broadly, if you have a bond and are worried that, should you need to cash out, rates would have risen and your bond will be worth less, you'll choose instead to just hold money rather than take a hit. So the ability to fix expectations of future rates very low would mean people not having to worry about potential rate raises, which makes them happy to buy and hold bonds. It is through the liquidity preference and uncertainty of future rates that the monetary authorities can then act through open market operations to shape broader macroeconomic outcomes.

It this way Keynes's monetary work - articulated in his *Treatise on Money* (1930), the *General Theory* (1936) and then *How to Pay for the War* (1940) - outlined his critique of the orthodoxy, and it provides firmer ground to debate whether a revolution in policymaking took place in his image. Keynes departed from Marshall and Pigou in arguing that the economy should be conceived of as a system in its own right, rather than another 'market' as in the classical cannon (Mitchell, 2005). In doing so he brought the insights of the monetary theorists to bear on the nascent neoclassical economics. The Keynes of 'pump priming public works' that critics pounded in the 1970s (for example Buchanan and Wagner, 1977)



only really applied to the arguments he put forward in *The Means to Prosperity* in 1932, and was specifically about using loan-finance to address depression conditions (Giovanna et al., 2004). Once the initial stages of the recovery were in place, Keynes stressed the importance of what could be termed more monetary forms of governance. In the *General Theory* he wrote how the central bank could try to fix long-term interest rates low, so as to counter the systemic liquidity preference that undermined investment, stating that “perhaps a complex offer by the central bank to buy and sell at stated prices gilt-edged bonds of all maturities, in place of the single bank rate for short-term bills, is the most important practical improvement which can be made in the technique of monetary management” (Keynes, 1978, p. 206). Indeed, he argued against the idea of the Treasury attempting to ‘fund’ the public debt (paying down the ‘floating’ debt) because this risked preventing a further fall in long-term interest rates (Moggridge & Howson, 1974, p. 240).

I make these points to clarify how important it is to judge Keynes’s work and his influence in terms of this monetary thinking. Doing so puts the question of the Keynesian revolution on a different footing. Rather than bundle Keynes up with a series of normative commitments about the purpose of government action in the economy, I argue it is more fruitful to assess the revolution through what tools were constructed to try and bring Keynes’s alternative conception of the need for ‘governance’ of the economy into being: the means of Keynesianism, rather than the ends. When assessed this way, our understanding of Keynes moves beyond the caricature of public-works spending. As a result, the issue of monetary policy and debt management returns to the story of the Keynesian consensus.

Few economic historians or political economists address Keynes’s work on public credit or the issue of debt management and liquidity more broadly. Though there is now a small group of monetary Keynesian authors that have followed from Victoria Chick (1983) and Geoff Tily (2010) and blame the triumph of the neo-classical synthesis and ISLM model for sidelining Keynes’s monetary insights<sup>6</sup>, I’d argue that this also reflects how difficult it has been for people to address the way in which public debt has monetary functions that have been instrumentalised to empower the state. It is a history that often fades out of view. Though authors (Howson, 1974) have noted that the Bank of England’s “obsession” with the

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<sup>6</sup> See for example Tily (2010, pp. 102–113), and Chick and Tily (2014).

enormous debt accumulated through the first world war, they believe the issue receded after the conversion of the war debt to a more long-term debt in the 1920s (Tomlinson, 1985, p. 42). It is a strange omission. Keynes was important in pressing for and designing the conversion between the wars and he was the dominant voice on the National Debt Enquiry Commission that was established by Attlee and Dalton in 1945 (Moggridge & Howson 1974). When contextualised within the time he was writing we see that Keynes made liquidity management a crucial part of central governance, building on the work of Bagehot and Hawtrey before him. In this public debt served as a tool - something to be instrumentalised - rather than an ogre to be avoided. One tool was using debt to finance counter-cyclical public investment - this is well known - the other was to use the management of public debt securities to increase liquidity which was essential in keeping the economy from stalling because Keynes felt people's uncertainty about the future made them reluctant to part with their money and invest in a way necessary to ensure growth.

In the following section I examine the attempt to translate this monetary thinking into practice in the postwar period of "cheap money" and how this flooded the system with too much liquidity.

### 3.2 Monetary management of the debt state

When the monetary aspects of public debt are acknowledged it becomes clear how public debt is used for much more than simply meeting a government's fiscal needs. Rather public debt puts in place a monetary infrastructure that can be manipulated by the state to govern the economy. For precisely this reason the politics of public debt involve more than simply meeting the imperatives imposed by creditors. It was the place of public debt securities in the broader monetary infrastructure that allowed Keynes to make his theoretical claims about the possibilities of using public debt to govern the broad flows of liquidity in the economy.

In what follows I examine what happened in the attempt to translate Keynes's ideas of debt-based governance into practice. Keynesian governance in Britain was about trying to mobilise public debt securities as a way to counter the systemic liquidity preference in the economy which Keynes argued undermined investment and put a ceiling on economic growth. As such the first attempt to do this saw the establishment of 'cheap money' during the second world war, and the

immediate period that followed. The 'cheap money' period is often discussed in simple terms as a brief time of abnormally low interest rates which ultimately resulted in inflation, one that was quickly resolved when interest rates were increased by the Conservative government in 1951 (Allen, 2012a, p. 813). Yet closer examination of the mechanism by which public debt securities were used to try to lower interest rates, reveals the lasting significance of the 'cheap money' period.

Though the 'war economy' is much discussed, often the focus is on the various innovations in planning and controls, so it is worth restating the dramatic impact the second world war had on the scale and mechanism of public finance. The second world war witnessed one of the largest ever increases in public expenditure, financed through one of the largest ever increases in public debt, which was secured on very low rates of interest (Tily, 2006). It was a remarkable achievement that owed much to Keynes. During the war Keynes advised the British government to secure a significant proportion of borrowing from banks directly, through issuing Treasury Bills (and similar short-term public securities), rather than relying mostly on external long-term investors on the gilt market (Tily, 2006, p. 666). As such the monetary authorities in Britain worked with the macroeconomy's systemic preference for liquidity rather than against it when financing the war. And on the basis of this success in wartime financing, Keynes was keen to continue the idea after the war to finance the reconstruction effort, proposing to the National Debt Enquiry committee that "the technique of tap issues, by which the preferences of the public rather than of the Treasury determine the distribution of the debt between different terms and maturities, should be continued into peace-time" (Keynes, 1980, p. 396). Broadly the thinking was that if people only want to hold short-term securities than the authorities should let them.

To recall, when Clement Attlee took power in 1945 the productive capacity of the British economy was battered and the national debt stood at £21.4 million - 225 per cent of GDP (Nield, 2012). The British state was, in that sense, entirely debt dependent, and by that stage the public debt was enough of a concern for Attlee to commission a National Debt Enquiry Committee, tasked with examining monetary policy and debt management as foremost policy issues facing postwar Britain. The policies adopted in response drew heavily from Keynesian thinking on the need to counter the systemic preference to hold liquidity which risked dragging back the economic recovery.

Keynes wrote how a “reduction of the long-term rate of interest to a low level is probably the most necessary of all measures if we are to escape from the slump and secure a lasting revival of enterprise” and that the best way of keeping rates low across all maturities was for “the market” to “be supplied with securities of different types and maturities in the proportions in which it prefers them” (Keynes, 1982, p. 115) which involved keeping the ‘taps’ open for Treasury Bills to be issued and redeemed at fixed rates for whenever demand arose from clearing banks and discount houses (Tily, 2010, p. 60). His proposals to the National Debt Enquiry committee laid out specific instructions for the “Bank Rate to be reduced to 1 per cent... Treasury bill rate to reduced to [0.5] per cent and Treasury Deposit Receipts to carry [0.62] per cent... 3 per cent Savings Bonds on tap, a new series to be started annually, with an option to the Treasury to repay after 10 years and with, preferably, no final maturity” (Keynes, 1980, p. 399). As Tily (2010, p. 77) wrote “These proposals went on to underpin the cheap-money policy of the post-war Labour Government under its successive Chancellors: Hugh Dalton, Sir Stafford Cripps and Hugh Gaitskell”.

What is clear then is the cheap money policy that followed the war was a form of monetary governance that pivoted on using the management of public debt securities to adjust systemic liquidity flows in the macroeconomy. Yet using government borrowing in this way meant, as Ursula Hicks wrote in 1954 (p. 171), “expenditure can be made, and additional incomes distributed, without any member of the public having to curtail his outlay, as he would have to if the expenditure had been covered by taxation” (or indeed financed through gilts paid for out of savings). Nonetheless creating ‘wealth’ through government debt financing after the war was a delicate operation. The scale of the public debt posed a potential problem where there was still the need to attract buyers of long-term gilt finance - who of course would only do so at high yields - while at the same time trying to ensure the cost of servicing the public debt did not curtail postwar reconstruction. It is why for Keynes the answer was straightforward, rather than fund the debt through gilts sold to investors, the wartime policy should be continued by financing the debt through borrowing directly from the banking system by issuing liquid assets - like Treasury Bills - to the banking sector.

In the balance between the use of long-term finance raised by the Bank of England selling gilts on the London Stock Exchange, versus the use of short-term finance raised by the Treasury issuing Treasury Bills and similar instruments to the

domestic banking system, the two world wars and cheap money period that followed rapidly expanded the use of the latter. The Treasury Bill issue grew from around £1.1 billion at the outbreak of the second world war to £4.2 billion in 1945 and stood at £5.5 billion by 1951 (Wadsworth, 2013, p. 149). In that sense, Treasury Bills, which of course were barely used until the first world war (Hicks, 1954), were becoming an ever more important part of the banking system, financing 20.6 per cent of Britain's total debt holdings by 1951 (Allen, 2012a, p. 36) and acting as the main constituent of the clearing banks' liquid assets (Wadsworth, 2013). These two different forms of debt financing represent the difference between the 'funded' debt: that comes from private sector savings, and the 'unfunded' or 'floating' debt that comes through short-term issuing assets to payable to the banking sector (Wadsworth, 2013, p. 60). As I will discuss the structure of the national debt finances was to become an object of political contestation itself, with different governments preferring different instruments.

The use of the 'floating' debt to finance Attlee's postwar government came from Keynes's argument that active monetary governance was needed to ensure liquidity was cheap and private sector investment would grow. His concern, which was shared by both Labour chancellor Hugh Dalton, and Attlee, came from the shadow of the interwar period that loomed large on policymakers after the second world war (Allen, 2014, p. 7). During that period Hawtrey's interest in restraining liquidity won over Keynes's advocacy for the opposite, and the high Bank Rate that was set as a result worked only to deepen an enormous recession. Dalton and Attlee were wary not to repeat the same mistakes. Cheap money was also pragmatic because low interest rates helped keep debt servicing costs down. Over the course of the 1920s, for example, the cost of servicing the first world war debt had absorbed 40 per cent of the country's budget (Pollard, 1989, p. 97).

Politically, 'cheap money' was attractive too. The interwar period saw the place of Britain's financial sector politicised on a number of fronts. Industrialists, like the famous business tycoon and county cricketer Dudley Docker, led national campaigns bemoaning how British merchant banks invested overseas rather than at home (Newton and Porter, 1988, p. 54). Meanwhile, Keynes had critiqued both the harsh terms of credit and the financial sector's general indifference to the needs of productive industry (Keynes, 1981). The 1925 return to the Gold Standard - which necessitated high interest rates - made the Bank Rate an issue of public debate, with manufacturing exporters complaining it undermined their prospects. In

response Hawtrey outlined how the City was a crucial source of “invisible earnings” that could help arrest declining export earnings, arguing that: “The shrinkage of [financial] business is a serious evil... The greatest factor in the material prosperity of this country is not manufacturing but augmented carrying trade” (in Green, 1991, p. 209). The Great Depression and economic stagnation that Keynes felt came from an excessively stringent attitude towards liquidity control is what underpinned his famous call for a “euthanasia of the rentiers” and the “socialisation of investment” that he felt was needed to avoid a liquidity trap (Keynes, 1978, p. 378). It was why Labour’s 1945 manifesto proposed that the Bank of England be brought under public ownership so that its operation and those of other banks could be “harmonised with industrial needs” (Labour party, n.d.). All of which is to say that after the second world war, the banking sector was expected to play as much a part in the peacetime effort for reconstruction that it had helping to fund the war. This was the political foundation behind the cheap money policy.

To enact the postwar policy of ‘cheap money’ meant restructuring the national debt to tilt the balance even further towards ‘floating’ short-term instruments and away from the ‘funded’ long-term securities that drew from savings (Hicks, 1954). This monetary management of the debt had broader effects on the banking system for the reasons I alluded to above. Treasury Bills were accepted as a reserve asset in private banks, which meant that the greater the number of Treasury Bills in circulation, the greater the stock of loanable funds which the banks had available to advance (William Allen, 2015, p. 2). As short-term loans, Treasury Bills had lower yields so if government could change the makeup of its debt to be funded more by Treasury Bills than by gilts, short-term interest rates could be reduced. Moreover, following from Keynes, the monetary authorities were of the opinion that long-term (gilt) rates were set by expectations of future rates, so if short-term rates were set consistently low, then long-term rates would follow suit. Through this Dalton hoped to force short-term rates down from 1 per cent to 0.5 per cent with the aim of driving long-term rates down to 2.5 per cent. To do this the monetary authorities refused to issue government securities at yields higher than 2.5 per cent, and was prepared to accept whatever maturity schedule investors thrust upon it (Allen, 2014, p. 7). Understandably, many potential investors refused to buy gilts at such low yields which meant the Bank of England had to step in as a “buyer of last resort” of its own securities (William Allen, 2015, p. 2).

That the monetary authorities felt able to pursue this programme shows both the significance of Keynes's influence on them and demonstrates how the state used the monetary infrastructure established through public debt to empower itself. This is a perfect example of the monetary mechanisms of debt management that traditional accounts founded on debt unsustainability find difficult to conceptualise. The banking system in England had evolved in such a way that the state could at once issue and purchase its own securities, to the extent that during the cheap money era, the Bank of England became a net purchaser of gilts from the financial system (Allen, 2012a, p. 21). These gilts were bought by the Bank with cash, which meant it was injecting cash liquidity into the banking system. In a round-about way this arrangement succeeded. Worried that excessive cash liquidity could lead to inflation, some investors chose to hold gilts, even at low yields, rather than sit on their piles of cash. This allowed some of the cheap money policy to be fulfilled with long-term gilt sales, which was a real boon for the authorities. However, the large proportion of the cheap money policy was achieved by funding the national debt through short-term Treasury Bills instead of gilts. This transformation of the state's debt maturity was the backbone of Dalton's money management and the result was a substantial increase, to the value of £1,026 billion, in the amount of Treasury Bills in the financial system between 1945 and 1948 (ibid.). As a result between January 1946 and January 1947 alone deposits of the 11 clearing banks rose by £900m - twice the average wartime growth - purely as a result of the way public debt was managed (Hicks, 1954, p. 203).

This is the crucial context on which to read the important turn in the postwar Labour party's economic strategy. In 1947 Britain suffered a clutch of economic crises that centred around the commitment to dollar convertibility. To recall by 1945 Britain had a cumulative balance of payments deficit of around £10 billion. Export earnings were around £350 million a year, while invisible receipts brought in a further £450 million. This compared to £2 billion a year spending on overseas military and food bought from the US alone (Cairncross, 1991, pp. 26–27). Coming out of the war Britain had £610 million of gold and hard currencies (dollars, mostly) in reserve underpinning sterling liabilities of £2.45 billion (Allen, 2014, p. 5). In that way Britain's finances were like a bank with insufficient liquid assets (ibid.). At this time many of the colonial holders of sterling denominated public bills were controlled - blocked from converting their sterling holdings into dollars - so the authorities had some cushion (ibid.). But a concern emerged that pumping cheap

money liquidity into the domestic financial system through the substantial expansion in the floating debt risked inflation.

As such the opposition to the programme of debt financing was framed not in terms of the solvency of this debt, but whether the restructuring of debt into short-term assets in banks swelled the money supply too broadly. In a sense this was a question about whether liquidity was excessive and needed restraining so as to avoid inflation - as Hawtrey had outlined in the 1920s - or whether government, by cultivating liquidity, could help private investors build the productive capacity of the economy. The *Economist*, for example, complained in 1946, "Mr. Dalton has littered the British economy with dry inflationary paper" (12 Oct 1946 cited in Hicks 1954, p. 203).

The response by the Labour government was to reduce the government's outlays. This took the form of an austerity budget in 1947 that was repeated by Dalton's successor as chancellor, Stafford Cripps, for the remaining years of the Attlee regime (Kerr, 2001, p. 97). When scholars revisit this 'turn' in Labour strategy they depict it as a case of the City-Bank-Treasury interests reasserting itself and forcing a return to balance-budget, Treasury View orthodoxy. In holding onto the budgetary ideal of Keynes, writers like Kerr (2001), Peden (1991) and Tomlinson (1985), see the 1947 budget as an explicit attempt at Keynesian-style demand management, but in pursuit of the 'orthodox' ends of sound money. Or, as Bulpitt (1986) suggests, though Keynes was influential, the "oral tradition" in the Treasury around the myth of Gladstonian 'sound money' finance, neutered the ambitions of Attlee's reformist government. As Kerr (2001, p. 92) writes: "Apart from the creation of welfare institutions, the Attlee government did little either to create new state structures or, indeed, to dismantle old ones. At no point did it take steps towards effective central planning, nor did it disrupt the stranglehold that institutions such as the Treasury, Bank of England and City of London had traditionally held over policy." As such it is on this basis that many argue the Keynesian revolution never quite took form under Attlee.

Yet ignored in this is how the austerity budget of 1947, or indeed Stafford Cripps' commitment to balanced budgets, could not be simply read off the dollar convertibility problem or the reflex for "orthodoxy", but came from the impacts of the monetary expansion that was forged on Keynesian thinking. It was the unique way Treasury Bills had been entirely institutionalised within the banking system that implied a particular structure for public debt financing, which in turn necessitated an



attempt at an austerity budget. None of this is to deny that the American pressure for convertibility was insignificant, nor that the City of London had no interest in sound money, but the fact Attlee's government took the turn it did should not be explained without reference to its earlier efforts of expansionary Keynesian monetary governance.

The legacy of 'cheap money' did not end here, however. It continued to present a problem for policymakers through the 1950s. In part this was because Keynes had developed his view about the efficacy of liquidity management in a context of wartime controls on the economy. He was very aware of the inflationary threat excessive liquidity could risk (Tily, 2010, p. 205), but felt that when consumer spending was curtailed by rationing, and when clearing bank advances themselves were subject to quantitative and qualitative control by the Bank of England, inflation risk was not the most important issue (Hicks, 1954, p. 192). Indeed, though reluctant to use it - lest expectations get skewered - Keynes argued the Bank Rate could be adjusted. In this way the linkages public debt had created between the central state and the banking system, and therefore the broader economy (as conceptualised as aggregate liquidity figures such as GNP), meant public debt could be used for the purpose of economic governance. As I've said before, a tool to be used, rather than avoided.

Nonetheless the cheap money policy had an effect that Keynes did not anticipate, and it worked to undermine the monetary authorities' capacity for monetary management of liquidity and with that the efficacy of state governance of the economy more broadly. The ability of the monetary authorities to influence the broad financial system (rather than the price of Treasury Bills specifically) came from the way the Bank of England hooked through the discount houses to the clearing banks. To recall, the discount houses were obliged to buy Treasury Bills whenever the Bank of England felt it necessary, and by forcing the purchase of Treasury Bills, the Bank could drain the cash from the system. This meant that to replenish their holdings of cash (with which to lend on to clearing banks when needed) the discount houses had to borrow from the Bank and because the Bank was the ultimate supplier of cash it set the rate on bills - the Bank Rate (Allen, 2014). This was the system that arose, as much by accident as design, over the course of the nineteenth century. Yet the continual issue of Treasury Bills meant they had become the dominant liquid asset deposited in clearing banks by the 1950s, with banks well above the 30 per cent liquidity ratio they were supposed to

maintain (Collins, 1988, p. 359). During the war the floating debt had been used to finance central government spending, but immediately postwar it was the capital requirements of local authorities and the newly national industries that increased state debt (William Allen, 2015, p. 9).

The effects of this were felt when the Conservative party returned to power and tried to move away from the cheap money policy. As I describe in the next section, they found that the excess of Treasury Bills in the system neutered the potential of the Bank Rate to affect domestic liquidity. In so robbing policymakers of a key tool of governance. Their response was to rely more on the government budget instead, which worked to grant a power to the Treasury that it had never had before.

### 3.3 The liberal compromise: Consumer Keynesianism

The common understanding of Keynesian governance as counter-cyclical fiscal spending has already been brought into question by the examination of the mechanism by which the ‘cheap money’ policy was implemented. Moreover, by examining how Keynesian theory was translated into practice I showed how ‘cheap money’ demanded a great expansion in Treasury Bill financing, demonstrating one of the ways in which the dynamics of public debt encompass more than simply financing fiscal spending. In this sense reference to excessive public debt or the state’s dependence on private creditors does little to clarify the specific problems that policymakers are confronting at any one moment. When analysed in terms of how public debt securities are used for the purpose of liquidity governance, the politics of debt take on a different shape. In what follows I show how the Conservative government’s attempt to restate monetary policy meant the state had to take on a much more direct role in managing liquidity. This it did through budgetary adjustments which in doing so greatly empowered the Treasury to an extent that had never been the case previously. Though writers like Geoff Ingham (1984) depict the Treasury as having been the centre of policymaking power in the British state since Gladstonian times, I show how it was Keynesian public debt management that in fact really transformed the Treasury into the central governor of the British economy.

## The failed return to monetary policy

The promise of the Attlee government that spent its first two years restlessly reforming Britain's political economy before its 'turn' to austerity in 1947 had fizzled out by the end of its term. Nonetheless the return of Churchill's Conservative Party in the 1951 election was a significant shock. The Conservative decade that followed has come to be cast as a decade of continuity, with bipartisan agreement for 'Butskellist' soft Keynesian governance. Yet Churchill had come to power promising to set people free from the state controls on the economy like rationing that had followed the war. Drawing from Hayek's *Road to Serfdom* which had been articulated in the UK most pressingly in Richard Law's *Return from Utopia*, he fermented a sense of a country in need of a liberalisation drive (Kelly, 2002, p. 96). The party was, by Ingham's (1984, p.206) reckoning, "intent on restoring market capitalism". Though the Conservatives' 13 years in power were not entirely harmonious, and certainly there was an internal battle between more classical liberal, Gladstonian forces (represented by Churchill himself) and the more corporatist, one-nation vision articulated by Harold Macmillan (Kerr, 2001), I argue that there emerged a governance regime forged on budgetary control of liquidity flows in the macroeconomy.

Initially, this wasn't the plan. The Conservative party, led by their chancellor Rab Butler, had hoped to restore monetary discipline, by abandoning direct controls on the banking system, and undertaking what was described as a "return to monetary policy" with higher interest rates (Kelly, 2002, p. 221). The problem he was trying to fix was not so much the inflationary consequences of growing liquidity, but the effects it had on the balance of payments. With Britain needing dollars to make international payments, and unable to generate enough through export earnings, gold and dollar reserves were being bled to try to restrain speculative attacks on the fixed value of sterling. Butler hoped that by raising the Bank Rate he could attack the balance of payments problem on two fronts, first by draining the domestic banking system of the liquidity that fed imports, and second by attracting foreign savings into Britain. Though this would increase the cost of servicing debt, it was a cost he deemed necessary (Allen, 2014).

He began in November 1951 with a largely symbolic 0.5 per cent rise in the Bank Rate to 2.5 per cent, before another more purposeful increase of a further 1.5 per cent in so that the Bank Rate had jumped to 4 per cent by March 1952 (ibid., p.21). This was achieved partially by Bank of England diktat (on the discount

window) but his broader intention was to restructure the maturity of Britain's debts. This meant reversing Dalton's work by trying to swap short-term Treasury Bills for long-term gilts; or switching from a floating to funded debt. In a small way the policy was moderately successful. It did help lower domestic liquidity to some extent, as banks stocked up on more gilts than they did Treasury Bills, and in doing so lowered their reserves of loanable funds (Allen, 2014). Yet it never quite fulfilled Buttler's hopes of reactivating monetary policy. This was because of the sheer excess of the stock of Treasury Bills in the financial system.

The clearing banks had so many Treasury Bills in their reserves that when they needed liquid funds to lend on to willing customers they could just wait and let these bills mature, pocket the cash and make the advance, and so had no need to turn to the discount window where the Bank Rate had been raised (Nevin and Davis, 1970, pp. 261–2). This problem was exacerbated by a second issue, which was the growth of institutional investors. Banks who had bought gilts and were in need of liquid funds could turn to pension and insurance houses, instead of the discount market. They would sell gilts and collect cash thereby swapping long-term illiquid assets for cash that could be loaned onto customers (Allen, 2012a, p. 23). What it meant was the Bank Rate lacked the purchase over the broader economy that would allow for effective governance.

It was the impotence of Buttler's 'return to monetary policy' that led to the commissioning of the Radcliffe report to enquire into the workings of the monetary system. What it found was that since the government had become a "habitual net borrower in peacetime", and had used the floating debt to finance this, "debt management ha[d] become a major problem of policy. To a greater extent than between the wars monetary problems and the problem of debt management ha[d] become inseparable" (Radcliffe report, 1959, p. 189). Deprived of effective tools of monetary governance the government had only fiscal tools in its armoury. This was not what Keynes had intended. Interestingly, the Radcliffe report is now mistakenly taken as representing a high-point in the influence of Keynesian thinking (Kenway, 1994; Laidler, 1989a), because of its insistence that monetary policy could only ever be a handmaiden of fiscal policy. Yet this overlooks the fact that Keynes did not initially place much significance on fiscal interventions, and moreover ignores that a key reason why fiscal policy became so important was because monetary policy had been rendered mute by the earlier period of 'cheap money'.

## Building budgetary Keynesianism

To manage liquidity in the fine-grained way Keynes's thinking implied - with counter-cyclical adjustments - meant developing a more precise understanding of the liquidity dynamics between public debt, the government budget, and the impacts this had on the balance of payments. The traditional image of Keynesianism as about fiscal injections came in Britain through governments trying to find alternative means to manage liquidity when monetary policy failed. This kind of budgetary management of the economy placed enormous importance in national accounting and macroeconomic indicators that had developed through Keynes's work in the *General Theory* especially (Suzuki, 2003). It informed a particular kind of Keynesian governance that made the government budget and the position of the Treasury the central part of political economic life.

There is a common misconception that the nineteenth century Gladstonian commitment to austere public budgets gave the Treasury great power over economic life in Britain. This power, when allied to the Bank of England and City of London, is what Geoff Ingham (1984) and others argue helped to choke off any possibility of a lasting Keynesian revolution in Britain. This idea, however, overestimates the scope of the Treasury during Gladstone's time and underplays how the development of budgetary Keynesianism in the 1950s worked to grant the Treasury greater power over economic life in Britain than it had ever before. It is indeed the case that Gladstone's commitment to balanced budgets and sound money contrasted with the largesse of the fiscal-military state that had characterised Britain previously (Campbell, 2004). Yet the organisation of state finance at this time barely resembled the Keynesian period. Because while the Gladstonian Treasury may have had a tight control over the government's fiscal outlays (*ibid.*), it can hardly be said to have held much sway of the economy as a whole. Indeed, even as late as the 1930s, the Treasury barely had any information about the national economy, let alone the capacity to control it. This incapacity was transformed by Keynes. In order to establish budgetary Keynesianism, the Treasury was grandly empowered by providing it the means to 'see' economic activity across the country, and equipping it with the capacity to alter that economic activity. Crucial in this was the emergence of national accounting, and the macroeconomic forecasting models that built on them, both of which took place alongside and through Keynes's articulation about the need for governance. They are therefore crucial in understanding the nature of the Keynesian revolution in Britain.

As such in what follows I revisit the development of national accounting, and Keynes's contribution to it, before outlining how this led to a particular kind of budgetary governance that was necessary once Buttler's attempt to return to monetary policy had failed.

National accounts grew out of the idea of a national 'income' that had developed in the twentieth century through Alfred Marshall's *Principles of Economics* and Pigou's *Wealth and Welfare*. Yet it was only with Keynes that the concept of a national income became something articulable in a specific number (Tribe, 2015). Though national accounts in various forms had existed for centuries - for example Gregory King's in 1689 - with Keynes came an effort to develop national income accounts in relation to other aggregate monetary flows: consumer spending, investment, government spending etc (Mitchell, 2005). This was a substantial shift that came through the way Keynes's theoretical innovations coincided with the emergence of a sophisticated statistical infrastructure in Britain. The general principle of related aggregates (consumer spending, investment, government spending etc) were established in the *General Theory*, but these were not workable for policymaking at the time of its publication in 1936. Statistics in Britain were still so rudimentary at that point that even conceptualising the economy along the lines outlined in the *General Theory* was impossible. As Tribe (2015, p. 90), writes: "the *General Theory* proposed the existence of systematic relationships between variables whose precise dimensions remained indefinite, or disputed".

The statistical infrastructure that made Keynes's ideas actionable had to be constructed. In this the war was crucial because it brought academic economists and mathematicians together in government service. Keynes worked alongside these mathematicians who were intent on developing practical statistics. Though at this point there existed basic statistics around the concept of the 'strength of a nation', these were not sophisticated or granulated enough for the purposes of Keynesian style national governance (Tribe 2015). Keynes and the statisticians he worked with were crucial in developing a conception of a 'national economy', with national income accounting helping to bring to life Keynes's idea of a macroeconomy with headline aggregates of monetary flows that could be manipulated from the centre (Mitchell, 2005). Other countries, like Germany, were developing similar national accounting frameworks by the end of the war, but only in Britain was there the kind of statistical infrastructure necessary to 'weaponise' accounting (Tribe, 2015, p. 66). These were features that had begun to form around

the interconnected financial system that had developed in the nineteenth century and the effort under Gladstone to try and ensure 'sound money'. Yet even 'sound money' governance amounted to little more than a 'nod' towards the levels of gold entering or exiting the country (Tomlinson, 1985, p. 32). A picture of the national economy as a whole and its relation to government was highly limited.

The more it developed the more it gave enormous new power to the central state. To recall, the impotency of monetary policy in the 1950s meant that 'demand management' had become a fiscal matter. This meant trying to control the macroeconomy through the once-a-year government budget. This required a substantial new apparatus of policymaking. As Alec Cairncross, who was a senior economist in the Treasury later put it, until the 1950s there were "virtually no official aggregates of the kind we now take for granted: no GNP, no index of industrial production, no balance of payments (except in very tentative form), no adequate consumer price index, and so on" (Cairncross 1988: 12 cited in Suzuki 2003, p. 478).

The first articulation of national accounts in the Keynesian sense came in the 1941 publication of UK National Income and Expenditure statement, a year after Keynes laid out the framework in *How to Pay for the War*, but as Cairncross's remarks suggest, it took time for the necessary indicators to develop. As they did, they became the pillars upon which were constructed the Treasury's understanding of the economy, the challenges it faced, and the political controversies these implied. The development of national accounting and the other macroeconomic indicators owed very little to the creditors that were financing the government, or the supposed grip of the City-Bank-Treasury nexus, though national accounting did provide a new language with which to articulate their concerns.

This is apparent in the way the balance of payments problem came to be tackled in the 1950s. Initially, to recall, Buttler had tried a higher Bank Rate, but given its failure, policymakers now depended on a fiscal solution. In the first form of the national accounts, outlined in 1944, Keynes had modelled the balance of payments through international trade multipliers (Tomlinson, 1985, p. 43). Yet in 1951 James Meade, who had worked with Keynes to construct national accounts in the first place, developed a model that systematically linked consumer spending aggregates to the balance of payments. Rather than rely on a muddy, loose notion of the impacts of "easy" or "dear" money, how this might relate to consumer spending, and how in turn this could affect the balance of payments with higher

imports, Meade's model showed the Treasury precisely how an increase in consumer spending would "leak" out of the system into higher imports (*ibid.*). It also systematically outlined how the government budget related to consumer spending, and in doing so designated great significance to the way the budget - which was developed at the Treasury - could impact the broader fortunes of the British economy.

The means of governance constructed through Keynes's thinking on liquidity meant intervention was less about direct control of industries or particular kinds of productive planning - which, when they did exist under Attlee owed more to wartime controls than anything else (Kelly, 2002) - and instead was more about managing broader economy-wide aggregate monetary flows. That is precisely why the Treasury's grip on the economic fortunes of the country grew through the Keynesian revolution rather than worked against it.

Precisely what control central government had over these broad monetary flows therefore became an important issue in the 1950s. The options for fiscally-led adjustments were limited, however, by the nature of the national accounts, the models that were crafted on them, and the way they were calculated. In the 1944 White Paper on Full Employment it was government spending that was supposed to carry the burden of fiscally-led adjustments to macroeconomic demand. Yet in practice, the only lever through which government was deemed capable of affecting aggregate demand was consumer spending, and that solely through the means of variations in taxation (Price, 1978, p. 77). This was because investment expenditure and government expenditure were treated as external, which meant consumer spending was the residual that had to be controlled<sup>7</sup> (Dow, 1970, p. 181). Consumption was the only monetary flow that could be varied rapidly (since consumers tended not to plan spending over the long term) and taxation was the only instrument through which it could be adjusted. Moreover, consumer spending was especially potent because it accounted for two thirds of national product, half of final demand, and after Meade's work, had also been shown to be a crucial

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<sup>7</sup> Successive governments from Churchill's 1951 regime onwards modelled both government and private investment as unchanging and pre-determined in their calculations because of their long-term scale (Dow, 1970, p. 182, *my emphasis*). Broadly, forecasts assumed that government investment was long term, planned, neutral and would not vary much on a year-to-year basis. Private investment, meanwhile, was complicated and required advanced preparation and again, took time to carry out which made yearly variations difficult to conceptualise, and in effect closed them off to policymaker influence (Dow, 1970, p. 181).



determinant of the balance of payments (Dow, 1970, p. 182). Again here it is difficult to really account for the influence of creditors in the financial sector on this architecture of governance. Certainly the balance of payments was a constraint on government policy, but its response was shaped by the way national accounting tools had constituted the appearance of the ‘problem’ and the available options to tackle it.

As such what came to be known as Britain’s “stop-go” cycle through the 1950s was the different trajectories of government spending and tax strategies. Generally, despite how the sceptics of the Keynesian revolution deem the period as upholding Treasury orthodoxy (for example Peden, 1991; Kerr, 2001) governments through the decade were geared to “go” with Churchill and MacMillan running deficits through the first half of the 1950s<sup>8</sup>.

The development of national accounts and macroeconomic indicators gave potential buyers of British public debt a more systematic way to assess their worth. Thanks in part to the Keynesian apparatus of calculation, the stability of sterling was understood by reference to both the balance of payments, but also to the level of growth in the economy. The national debt stopped being expressed in absolute terms, instead a more relevant figure that came into use was the proportion of debt to GDP (Tribe, 2015). Conceptualised in such terms debt took on a more manageable form, and the solution to debt sustainability became not just repayment but through the growth of the national income. As such the ‘stop’ part of the stop-go cycle was tricky. Because in order to improve the balance of payments government felt it necessary to dampen consumer spending which leaked into imports. But running a deflationary budget risked undercutting economic growth, and slow growth risked calling into question the solvency of Britain’s public debt.

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<sup>8</sup> This was in part to pay for the institutions of social reproduction like the NHS that had been established by Attlee, but mostly deficit finance was in fact used to pay for the development of Britain’s arms industry. As Edgerton showed, public spending on social services after 1948 was not significantly higher than before the war. Instead it was defence spending, which had obviously grown through the war, but less obviously continued to remain high well into the 1960s, that absorbed a significant chunk of the government’s budget. “In 1953 defence took over 30 per cent of public expenditure (net of debt interest), while health and social security took 26 per cent” (Edgerton, 2006, p. 66). This double pressure of government spending on both social reproduction and defence put pressure on sterling as deficits piled up, and bolsters the case that the financial sector was not the only significant lobbying group in British policymaking.

## The emerging politics of national economic decline

Public debt had taken on a new significance through the establishment of budgetary Keynesian governance in the 1950s. As Britain's economic decline and the necessity for 'growth' came to dominate political debate so too the position of the government as an economic actor came under closer scrutiny (Miller, 1990; Tomlinson, 1996). Whether by accident or design one implication of the way Keynesian thought translated into practice was that the sustainability of public debt became a question about the efficacy of the state as an economic actor, and its ability to generate growth.

The favourable international environment in the 1950s ensured Britain was able to grow throughout the decade (Cronin, 1991). It also meant British exporters were able to earn enough dollars - predominantly through forced trade with the colonies - to keep devaluation fears at bay (Kerr, 2001, p. 104). This, in turn, worked to contain the conflict within the Conservative party between the liberal elements that wanted deeper public spending cuts, and the one-nation Conservatives that didn't. Within the Labour party there grew a tension between its right wing that was happy to maintain the liberal budgetary governance based on Keynes's thinking, and its more socialist elements that wanted more direct planning of industry along the lines seen in France and Germany (*ibid.*).

Nonetheless the political mood was shifting. The Suez crisis had demonstrated to Britain the limits of its imperial future and there was growing dissatisfaction with the state of Britain's economy in comparison to its European and American competitors. Though there had long been worry about the relative unproductiveness of Britain's core industries, in the late 1950s and early 1960s an idea of a broader "national" economic decline took hold. The publication of C.P. Snow's *Two Cultures*, Arthur Koestler's *Suicide of a Nation*, and Michael Shanks' *The Stagnant Society* sparked a series of books on the subject of British economic decline (Edgerton, 1996). The development of comparative economic statistics through the 1950s lent weight to the growing dissatisfaction with Britain's economic fortunes. As one civil servant put it in 1961: "If it were not for the activities on an international scale of the economic statisticians, it is doubtful whether the present agitation would be anything like as noisy" (Tomlinson, 1996, p. 747). More and more 'growth' became the panacea to the clutch of problems Britain confronted. And as I show in the next section this, when combined with the Treasury's hold on the broad health of the British economy, this meant a politics of productivity took

hold that established the criteria on which to politicise the British government as an economic actor and its management of public finances.

At the turn of the decade the political ground was shifting much more explicitly onto 'economic growth' and the role of government in its cultivation. The language of British decline, and the promise of growth to arrest it, became an important political narrative, with the Labour opposition in 1961 publishing what economic historian Jim Tomlinson described as a key declinist pamphlet called 'Signposts for the Sixties'. "It set Britain's economic performance in an explicitly comparative context, contrasting unfavourably the country's share of world trade and growth of industrial production with that of other west European countries" (Tomlinson 1996, p. 752). It also stressed the need for active intervention in the economy in order to modernise Britain's flagging manufacturing companies through rationalising industry (Tomlinson, 2000). The 1964 election, as Edward Heath's biographer Campbell (1993, p. 163) wrote, was the first where decline and the necessity for economic growth was the central issue:

"The notion of Britain's relative decline - the realisation that in terms of economic prosperity, social services, and the 'quality of life' Britain was falling behind other industrialised countries - had struck the previously complacent public consciousness quite suddenly within the previous five years. It was to be the staple assumption of every subsequent election over the next three decades."

What emerged through the 1960s was a focus on corporatist modernisation of industry in the hope that growth could provide an ultimate fix-all solution to the problem of raising wages, inflation, balance of payments and employment. The 1950s period of stop-go budgetary policies had ended in 'go', and inflation was again running higher than desired, with balance of payments worsening (Kerr, 2001). That turned into a full-blown crisis after revaluation of the Deutsche Mark in March 1961 which blew another hole into foreign exchange reserves. The episode also sharpened focus on the stability of even 'established' countries' currencies. It was in this context of cross-party frustration that a report into "controlling public spending", to be chaired by Lord Plowden, was commissioned by the Treasury.

The Plowden report, which was published in 1961, noted how much had changed over the previous 20 years. Public spending was larger, more complex and entailed future commitments in a way never seen previously. "[The] Budget is seen," wrote Plowden (1961, p.6), "not as a simple balancing of tax receipts against expenditure, but as a sophisticated process in which the instruments of taxation

and expenditure are used to influence the course of the economy.” Yet despite this, Plowden noted the form of the budget had barely changed in the two decades since 1941 and that still “not enough is known about the relationship of public expenditure to the issues of growth and solvency of the national economy” (ibid.).

In the emerging discourse of “growthmanship” (Cronin, 1991) debate over what was standing in the way of British economic growth. Was it inflation arising from excessive wage demands; or were there deeper institutional problems in the British state itself? Plowden (1961) articulated the latter, arguing that despite the advances in national accounting and the development of macroeconomic indicators, there were still fundamental problems with the efficacy of the British state as an economic agent - and particularly within the process of budgetary decision making - that was in need of urgent modernisation.

As part of the focus on growth, in the early 1960s Harold Macmillan began moves towards a more corporatist arrangement that used the state in a more direct way in the economy than had been the case during the 1950s (Kerr 2001). Looking at the French example he saw the possible promises of indicative planning, and this became a theme for him and especially Harold Wilson’s first government that followed in 1964. There was certain support in the private sector for closer cooperation between government and industry in building long-term economic plans, but the form of partnership was geared towards using the government to broker an incomes-policy that would help contain wage growth (Kerr 2001, p.104). As such Macmillan made early moves towards an incomes policy, but Wilson’s election promised more substantial reform. As ever, the problem of the balance of payments lurked. I have mentioned the 1961 crisis and three years later Wilson faced balance of payments problems immediately upon entering office. In August 1964 \$1 billion standby credit was secured from the IMF and a further \$500 million from various foreign central banks (Green 2013, p.170) and he raised the Bank Rate after consultation with the American monetary authorities (ibid.). As Green writes it was at this point the Treasury began to take a more active role in trying to defend against speculative attacks against sterling, partnering with the Fed in a series of swap arrangements between central banks to build up a ‘war chest’ of finances.

Wilson’s solution was to promise to the Labour party conference in 1963 a transformation of Britain’s economy “forged in the white heat of the technological revolution” that would drive productivity and exports up, while also containing

inflation (Francis, 2013). In a nod to the now firm grip the Treasury had over broad economic life in the country, he established a new Department for Economic Affairs and Ministry of Technology responsible for developing a national plan with a longer-term horizon than the Treasury, whose more immediate problems with the balance of payments tended to dominate. Alongside this came a plethora of other state and para-state corporatist institutions like International Computers Ltd, the National Research and Development Corporation, the Industrial Reorganisation Corporation and others. The stated aim was to take British industry “by the scruff of the neck and drag it kicking and screaming into the twentieth century” (Hall, 1986, p. 89). The NEDC, Regional Development Corporations and the IRC were all established with an eye to solving what was thought to be a long-running problem in Britain (first articulated by Keynes to the 1933 Macmillan committee) of the lack of financial support provided to small and medium size enterprises (Hall, 1986). The hope was that para-state bodies could help channel City money towards domestic industry that otherwise was being under served by the financial sector.

Framed in this way it is perhaps not surprising that the ultimate failure of Wilson’s corporatism to deliver a productivity revolution came to be cast as further confirmation of the ability of finance capital to triumph over productive forces in Britain. Both Geoffrey Ingham (1984) and Peter Hall (1986) argue that policymakers’ steadfast commitment to low inflation and an overvalued sterling exemplified the hold the City had over a government that remained ultimately impotent in comparison; only ever the handmaiden to City interests. Again, however, this relies on a projection of what a proper ‘Keynesian’ government would have done and a normative commitment to the virtues of productive over financial capital.

Yet the corporatist drive of Macmillan and then Wilson had a curious effect on the government budget. Though efforts were made towards indicative and even more sophisticated planning, the central part of government action in the economy remained its budgetary policies. And though Wilson is now often said to have favoured Treasury orthodoxy, under his watch, government spending as a proportion of GDP grew and even stated attempts at deflation did not translate into deep public spending cuts (Keep, 2016, p.5; Kerr, 2011). Moreover, investment in the public industries continued apace. Following the Plowden report, effort was put into bringing the government budget and national income accounts closer together, and integrating forecasts of ‘public sector expenditure’ and GDP into the procedure

of government planning (Jones, 2000; 2003). This was deepened by the income-expenditure model that went the step further to project forecasts of government borrowing, showing systematically for the first time how different aggregate financial flows related to differing central government demands for credit (Kenway, 1994, p. 60).

The period politicised government as a generator of economic growth. Though there were not necessarily doubts about the solvency of public debt it was abundantly clear that sterling denominated securities were under threat because the government would not be able to maintain such large balance of payments deficits (Needham, 2014a). As Green (2013) argued, Wilson was never keen on devaluation, and the American monetary authorities did not want Britain to devalue, but Wilson felt unable to jump-start his corporatist revolution while exporters were being squeezed with such a high exchange rate.

The way that this situation developed cannot be read off the power of creditors and the financial sector restricting government to an orthodoxy unchanged from Gladstone. Rather it is precisely in the attempt to turn Keynesian governance into action that the Treasury was grandly empowered and that forecasts on how government debt related to budgetary interventions and GDP projections became such an important part of policymaking

### 3.4 Public debt, liquidity governance and monetary control

The emergence of budgetary Keynesianism in the 1950s was supposed to have granted the government the capacity to use its annual budget to manage aggregate liquidity flows. Though it was a potent weapon over consumer spending, it proved less able to generate the kind of productive investment that was Keynes's original interest in liquidity management. Hence the attempt at more direct, corporatist solutions. While the government continued to run deficits through most of this period, on the monetary side it had become more austere (Kerr, 2001). Ever since Buttler's attempt to restructure the government finances and fund a greater proportion of the national debt through gilts, rather than Treasury Bills, the discount window had slowly managed to re-establish its importance in shaping liquidity in the banking system (Allen, 2015). Indeed, if the monetary authorities were able to choke off liquidity created in the banking system, then its budgetary moves would be more potent.

For this reason, the high interest rates imposed during MacMillan and Wilson's time in power - something often considered to represent their subordination of industrial renewal to the interest of finance (for example Kerr 2001, Green 2013) - could perhaps be better understood as an attempt to make the government budget the sole engine of economic governance. It is important, then, at this point to examine how the authorities attempted to combine expansionary fiscal budgets with monetary control of higher interest rates and what this meant for the operation of the two key markets for government debt: the short-term Treasury Bill market, and the long-term gilt market.

To recall cheap money had flooded the banking system with such a large volume of Treasury Bills that the discount window had been rendered ineffective. The Radcliffe committee was established in May 1957 to examine the ineffectiveness of monetary policy over the previous years. It reported how debt was at once a major headache for policymakers, but at least offered scope for intervention:

“There is no doubt that it has, and can, exert this influence through the management of the National Debt which, if burdensome to the financial authorities in other respects, affords in this respect an instrument of singular potency. In our view debt management has become the fundamental domestic task of the central bank. It is not open to the monetary authorities to be neutral in their handling of this task. They must have and must consciously exercise a positive policy about interest rates, long as well as short, and about the relationship between them” (Radcliffe report 1959, p. 337)

British debt had stood at 237 per cent of GDP in 1946, and was still 175 per cent in 1951 (Keep, 2016), but the growth in the economy through the 1950s meant that by the end of the decade the public debt ratio seemed a more manageable 112.5 per cent (Allen 2014, p.245). In this sense the problem debt presented was not one of solvency per se, but the liquidity impacts that financing the debt implied. Over the course of the Conservative decade of the 1950s, Wilson, Eden and Macmillan ran repeated deficits, breaking with Labour's 'turn to austerity' in the final years of the 1940s (Allen, 2014). The result of which was an increase in both gilt and Treasury Bill financing, mostly to the domestic banking system.

The effort to at once finance the debt internally, run budget deficits, and try to contain potential inflation meant that in the latter half of the 1950s and 1960s, interest rates were kept unduly high. The big shift came in 1957 when Macmillan, who was chancellor at the time, insisted on a significant rate hike. Wary of the

growing inflation in the previous years and the inability of the existing control arrangements to curtail clearing bank advances the governor of the Bank of England, Cameron Cobbold suggested a big increase in rates and was supported, eventually, by Conservative chancellor Peter Thorneycroft. The result was a jump in the Bank Rate from 5 to 7 per cent (Allen 2014, p.130). This succeeded in choking off inflationary expectations for the rest of the decade and indeed monetary policy was fairly stable for the remainder of the period. It was, as the Radcliffe committee reported, fiscal policy that made the running in demand management.

Alongside the high Bank Rate there were a multitude of other controls on banks, which complimented the monetary authorities' effort to manage the public debt. Bank insiders at the time (for example Allen, 2014, p. 181) now describe the period as resembling a kind of 'financial repression'. The clearing banks faced the Bretton Woods restrictions on exchange, which together 30 per cent liquidity requirements and what was at that time still significant qualitative guidance from the Governor who more often than not was calling on them to slow advances. Collectively this meant that the clearers had little option but to hold government debt (which at least offered some interest compared with cash). As such the clearing banks were significant buyers of gilts and Treasury Bills, helping to finance government at rates more or less set by the monetary authorities themselves (ibid.).

These controls served to strengthen the tie that the government budget had with monetary control. As Thorneycroft said in the late 1950s, there were two sources of money: Government and the banks (in Allen, 2014, p. 128). Short of nationalising the clearing banks, which the more radical left on the Labour party advocated, the controls on the banking sector described above was all the monetary authorities had available to control the liquidity extended to the national economy by the banking sector. There were other possible quantitative controls on the banking sector that were mooted at the time, for instance ceilings on bank advances, but Cobbold considered them unworkable (Tily, 2016). It is why there was such attention given to the prospects of trying to control government spending and what provoked the commissioning of the Plowden report to inquire precisely into the operation of fiscal policy that I described in the previous section.

The monetary problems that plagued the British governments of the 1960s centred around the level of sterling, and culminated in devaluation in 1967. Yet as I described, throughout the period the discussion on monetary control was cast in fiscal terms, either jump-starting growth with the corporatist revolution - drawing on



the public exchequer if needed - or controlling fiscal spending through attempts at public sector wage cuts.

In that sense, it is easy to see how the Keynesian period has come to be cast primarily in fiscal terms. The legacy of cheap money combined with the vast wartime public debt to make government deficit spending the primary mode of economic stimulus and the attendant inflationary and balance of payments problems. The apparent failure of fiscal policy and attempts at industrial modernisation is taken as a sign of the financial sector's dominance in much literature, yet as I turn to in the following chapter, what I argue is much more significant was the way in which the monetary controls that had been established by the end of the 1950s, revolving around liquidity ratios, the high Bank Rate on the discount window and the clearing bank network, were being steadily eroded by a concurrent development of a parallel financial sector. Its impacts were to make monetary control a far steeper challenge.

## Conclusion

Consideration of the monetary aspects of public debt helps to recast the question of whether there was ever a Keynesian revolution in Britain. That is a debate that has been grounded in fiscal terms: whether or not the authorities in Britain departed from a balanced-budget framework of public spending. When, instead, the Keynesian revolution is posed in terms of monetary governance, it becomes clearer. It involved, initially at least, using public debt to try and increase liquidity and stimulate private investment. The specific steps necessary to enact the policy had a profound significance on the years that followed. The banking system was flooded with liquidity that worked to undermine the position of the Bank of England as the monopoly provider of liquidity. The result of which was to make monetary governance of the domestic economy incredibly difficult. From here the governments of the 1950s attempted budgetary governance of the domestic economy, relying on national accounting statistics and adjustments to taxes to influence consumer spending, a key result of which was to grandly empower the Treasury as a key institution at the heart of Britain's broad economy. As Britain continued to struggle with its external balances and repeated balance of payments problems, in the 1960s the idea of 'economic growth' pushed through by the state, became a very important grammar of politics, which meant the state and its finances came to be assessed in terms of its ability to generate growth.

In that way the Keynesian period demonstrated both the great potential, but also profound difficulty with managing the monetary aspects of public debt. The volatile dynamics of debt management were especially pronounced in an international framework for monetary governance that bound the state within the parameters of fixed exchange rates. As I show in the next chapter, when in the late 1960s money creation became ever more centred around private sector debt, the question of how to control liquidity became even more pronounced.

## 4. The credit revolution: The rise of 'parallel banking' in Britain

### Introduction

While prime minister Harold Wilson dreamt up his modern industrial revolution, 'forged in the white heat of technology', Britain's financial sector underwent a real-life revolution that was to have a far more enduring effect. Between 1955 and 1971 there emerged what became known as a 'parallel' financial sector in Britain that existed alongside and intertwined with the main, regulated sector. In the parallel sector private banks developed the capacity to issue their own debt as money on a scale far greater than before. The dominant position of public debt as the main source of liquidity was destroyed forever. And much like with the British state centuries before, the private banks' capacity to monetise their debts meant a rapid growth in credit creation. This credit found its way to individuals, households and businesses, ramping up levels of private debt in the economy that have only continued to climb ever since. The scale of this private-sector liquidity created through the 'credit revolution' revolved around the parallel money market whose emergence and growth undercut the traditional discount market and with it the dominant position that public debt securities - Treasury Bills especially - had had in the monetary system. It was a sharp decline: Treasury Bills made up 67 per cent of all sterling instruments in 1957, but by 1979 accounted for just 6 per cent (Collins, 1988, p. 361). In this radically altered environment the monetary authorities lost the direct control of liquidity in the financial system that had previously been established through their monopoly on Treasury Bills and cash. In this way a crucial avenue through which the state had used monetised public debt to govern the economy was undermined.

The monetary authorities lacked the capacity (and many have argued, the will) to stop the rapid credit that was created through the parallel sector. It is perhaps why the credit revolution, and the parallel sector in which it emerged, are often depicted as free-market success stories; cases where financial market innovation - for better or worse - trumped the regulatory apparatus (for example

Goodhart, 1986; Cobham, 2003; Congdon, 2004). As I have argued throughout this is symptomatic of the way debt is seen as growing to excess only in an institutional and governance vacuum. Even the use of the terms ‘parallel’ and ‘secondary’ banking implies that the financial institutions which made up the sector developed in abstraction from what was already in place. It is well established that the period between the late 1960s and mid 1970s saw the financial sector undergo significant change. Yet what the credit revolution meant for monetary governance is less clear. Often the period is depicted as hastening the demise of the state as a monetary governor and helping to establish a new regime of market governance in its place. The heterodox literature like Anastasia Nesvetailova (2007), for example, ties the monetary expansion witnessed in the period to the notion of a market-provision and market-governance of credit. In these accounts (see also Chick and Dow, 2013) the credit revolution unfolds as a story of ‘politically managed’ money giving way to an era of ‘market managed’ money.

In this chapter I argue that the notion of ‘market-led governance’ does not adequately specify how the emergence of the parallel financial sector transformed the possibilities and problems of monetary governance in Britain. The sidelining of Treasury Bills as the dominant form of banking sector liquidity did of course undermine a key basis of state governance, but the nascent parallel money market did not simply dissolve the centuries-old institutional infrastructure that revolved around the Bank of England. The Bank of England’s hold over the most deeply institutionalised debt, the public debt, meant it still carried great weight in monetary affairs. Without a central bank, the private sector banks would have found it far harder to monetise their debts (Mehrling, 2010). For this reason, it is unhelpful to depict the credit revolution as the development of ‘market governance’ in the financial sector. Rather, to grasp how private sector financial houses acquired the capacity to monetise their debts and dramatically expand credit, it is necessary to place the innovations in their institutional context. Doing so reveals how the secondary financial sector, in which the credit revolution was born, did not operate in parallel to the primary sector. Rather, they were deeply intertwined. What separated the two was not regulation as much as it was the entrance of American banks harnessing the technique of ‘liability management’: the use of money markets to buy the ‘deposits’ that allowed lending to grow (Cassis and Battilossi, 2002). Liability management came out of a highly-restricted American financial environment (Konings, 2011), and was brought to the British financial system

through London's hosting of the Euromarkets (Burn, 2006). The growing significance of liability management helped to expand the interbank borrowing market, undermining the traditional discount market in the process (Goodhart, 1982). Meanwhile, the development of the Euromarkets and the parallel money markets coincided with, and supported the broader development of, non-traditional banking in Britain. This came through the rise of hire purchase houses, Trustee Savings Banks, and Building Societies, which all worked to erode the dominance of the Big Five clearing banks in British retail finance (Collins, 1988). Taken together, British private finance was by the middle of the 1970s, becoming more highly leveraged, and capable of extending levels of credit that well exceeded what reserves would imply (Alessandri and Haldane, 2009)<sup>9</sup>. It is precisely because of the way bank debt could act as money that debt was able to grow so rapidly. As I have argued throughout, to take seriously this monetary aspect means tracking how private debt acquired monetary features, and how the monetary infrastructure this established shaped the broader financial system and the possibilities it offered for state governance.

In the first section of this chapter, I build on this argument to show how the credit revolution cannot be depicted as a market revolution. The critical story that is often told, of postwar 'regulation' giving way to post 1970s 'deregulation' does nothing to capture concretely what changes were necessary in order for private bank debt to acquire moneyiness. I argue that liability management was central, and its arrival into Britain through American financial houses facilitated the rapid growth of Britain's financial sector, and the attendant expansion of private sector debt. On this basis I suggest the key to grasping the dynamics of the credit revolution and its effects on governance is by examining how liability management operated in Britain. In the second section I show how Britain's financial sector was undergoing significant change in the period from 1950-1970, with the emergence of a broad parallel sector. This involved new retail financial houses - the hire purchase houses specifically - that undercut the clearing banks, and most importantly a new money

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<sup>9</sup> Alessandri and Haldane (2009) show how return on equity for UK banks jumped from around 5 to 25 percent between 1966 and 1972, the period I refer to broadly as the credit revolution, with banks rapidly reducing their ratio of liquid assets to total assets. Moreover, having declined since the end of the second world war, UK banking assets as a percentage of GDP began to grow rapidly in the late 1960s, crossing over 100 per cent of GDP by 1975.

market - the Euromarkets - which hosted international banks who established sophisticated techniques of liability management. The result of which was to establish a new practice of interbank borrowing as the crucial source of liquidity provision (Collins, 1988, p. 379). In the third section I examine how liability management operated and its consequences for monetary governance. The demotion of Treasury Bills as the primary source of liquidity meant that the Bank Rate was no longer a driver of short-term borrowing rates in the banking system (Needham, 2014a, p. 15). This was a major challenge for the monetary authorities and resulted in a series of ill-judged 'monetarist' reforms during the following decades.

#### 4.1 The credit revolution: Market-led governance?

##### The growing excess of debt

One key problem that arises when the monetary aspects of debt are occluded is that it becomes very difficult to explain how debts can continue to grow to such vast levels. For this reason when critical commentators, particularly heterodox voices like Ann Pettifor (2014) or Steve Keene (2011), come to write about the growth of debt they do so in terms of its inevitable unsustainability. They depict the explosion of private debt that took place through the credit revolution as a distortion from correct and acceptable practice. For this reason, there is a deep association in the literature between growing excess of debt and the idea of 'market' governance. If only there were an institutional infrastructure in place to 'ground' private finance, such growth would be impossible. It is why prominent post-Keynesian writers like Victoria Chick present an account of the credit revolution emerging alongside, and through, the state abdicating its role in monetary governance, stepping aside to let the market take over. Chick and Sheila Dow (2013), for example, describe how in the 'golden era' of a state regulated money, the financial landscape was characterised by "institutional specialisation, cartelisation, and a network of subsidies, privileges and responsibilities that knit[ed] the private financial institutions, the Bank of England and the Treasury into a mutually dependent system" (Chick and Dow, 2013, p. 2). This system began to unravel because of legislative changes in the 1970s that had the effect of leaving to the market what had previously been controlled by the state. Deregulation instilled an unprecedented situation where the Treasury and Bank of England "relinquished

responsibility for the control of credit and the money supply”, creating, “an entirely new position for the state vis-a-vis the nation’s money” (ibid.).

This had important implications for public finance because under the postwar system of ‘managed’ money the Bank of England had legislative power to demand the clearing banks retain eight per cent cash and 20 per cent of other liquid assets in easily-accessible deposit accounts (ibid.). The ‘cash’ deposits were held at the Bank of England, while the liquidity deposits were held as Treasury bills in the discount houses. In exchange for these restrictions, the Bank of England provided liquidity to the clearers through the discount houses, lending at the Bank Rate through the discount window. The arrangement empowered the state in three ways. Firstly, holding cash and Treasury Bills in deposit with the Bank of England provided the state with short-term finance. Second, clearing banks and discount houses that held gilts provided the state with long-term finance. Third, as the monopoly provider of state money on the discount market, backed by gold (via the dollar), the state could adjust the level of money creation in the broad economy as it saw fit.

By Chick and Dow’s (2013) account, these three sources of power were gradually relinquished as direct controls were swapped for market management in the 1970s. Reserve requirements fell, the link to gold was severed, and the clearing bank cartel dissolved. The compulsion to compete in the newly liberalised banking market meant the specialised and cartelised financial institutions that had characterised British banking gave way to a new arrangement where banks began to resemble each other more and more. Clearing banks soon began to offer interest on deposits and started competing for assets by offering lower interest rates on loans. This meant spreads were squeezed which, Chick and Dow (2013) argue, resulted in banks systematically lowering their reserves of liquid assets as much as they could in order to restore profit margins. This took place in a broader context of financial expansion through digital-technology-enabled globalised exchanges, the formal end to the dollar-gold link, and deregulation on the ‘demand-side’ of bank borrowing. Collectively there is a sense that the rapidly growing financial markets overwhelmed the infrastructure through which financial governance had taken place, supplanting it with a straightforward system of market governance.

This branch of heterodox literature is very keen to stress how in contemporary times banks have the capacity to create money as debt (for example Pettifor 2014). In explaining why there has been such a marked increase in debt

since the 1970s Montgomerie (2015) points at the fact that money creation comes now from the private sector. Yet there is an assumption in Montgomerie (2015), Pettifor (2014) and Chick & Dow (2013) that banks have gained this capacity solely by virtue of deregulation, as if money and debt grows only outside of an institutional infrastructure. The idea being that that once ‘allowed’ to by the removal of state regulations, banks have the capacity to rapidly extend credit. For this reason, it becomes very difficult to understand specifically how the state’s ability to use public debt securities to govern the economy was affected by the credit revolution. That this argument is often made by heterodox economists is especially surprising because it downplays one of the key lessons of Hyman Minsky’s foundational heterodox work. He demonstrated what institutional innovations were necessary for private debt to function as a form of money, and in that sense how deeply institutionalised credit relations were in the broader economy. In tracing out the institutional shifts I argue that it is liability management, rather than deregulation, that better captures the shift on which the credit revolution was forged.

Private money, market governance?

The credit revolution transformed the position of public debt securities in the banking system. Public debt, especially Treasury Bills, had become established after the first world war as the key source of liquidity in the financial system. This provided the state, through its monopoly provision of this liquidity, a monetary infrastructure through which to govern the economy through the postwar Keynesian period (Allen, 2012b). The impact of the credit revolution was that it saw private debt securities, in particular a new instrument called Certificates of Deposit, supplant Treasury Bills as the most important source of liquidity (Revell, 1973, p. 280). Given this broader role for private debt and private financial markets in the money market, it is easy to assume that monetary governance too was ‘marketised’. Yet to grasp more specifically how the credit revolution implicated monetary governance we need to see what it entailed and how it operated. This, I argue, comes by casting the credit revolution as a development in the technique of banking with the emergence of ‘liability management’ in Britain.

Through liability management the financial system acquired the capacity to extend credit to levels well beyond what any notion of reserves or deposits would imply (Earley and Evans, 1982). It began in the middle of the 1950s and took off at the beginning of the 1970s (Cassis and Battilossi, 2002, p. 108), and it transformed



the logic of banking practice. Rather than first raise deposits and then make loans, liability management involved banks first originating loans and then looking for corresponding 'deposits' to buy from the money markets markets. In that sense the new banking practice meant first growing the asset base, and then managing liabilities through money market operations. To do this banks needed a ready source of liabilities that could quickly be raised to facilitate their asset growth. For most of the twentieth century the main liquid liabilities in the British banking system were Treasury Bills and Bank of England cash. Though, as the 1959 Radcliffe committee report recognised, there were a number of other money-like financial securities (commercial bills of exchange, for example), it was public debt securities that dominated. The great shift that took place through the credit revolution was that private bank debt securities replaced public ones to become the dominant money-like security in the banking system, and as such the dominant source of liquidity (Revell, 1973). Driving this development in the monetisation of private debt was not 1970s deregulation, which followed later, but the development of the interbank money market through the practice of liability management. Without active interbank borrowing, bank securities could not be the dominant money-like financial security, and it would not be possible for banks to operate by a logic of 'creating money out of nothing' in the way heterodox commentators like Keene (2011) present bank practice today. Interestingly, though often overlooked in contemporary heterodox literature, Minsky (1986, p. 86) himself stresses how important the development of the interbank money market was in creating a financial sector capable of rapidly increasing debt.

Without the development of an interbank money market it would have been very difficult for bank debt to acquire the monetary functions it did through the credit revolution. This is because of the way banks operate, and the primary problem they face. As I will next explain, banks can be thought of as operating under a constant liquidity constraint. In order to lend out money on demand to customers they must always have ready access to liquidity, and there are three primary channels available<sup>10</sup>: First, a bank can borrow from the central bank's open market operations. However, if the central bank is trying to restrict reserve growth - as the Bank of England was in the late 1950s and 1960s - this would not be possible. A

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<sup>10</sup> This reformulates Minsky's description of money and banking as laid out in Minsky (1986) and (Dymski and Pollin, 1992).

second option is to borrow from the central bank's discount window, but again this comes at a cost when the Bank Rate was being increased to precisely to limit credit creation. The third option is to raise cash directly from the open money market through issuing debt securities. It was this third option that became so significant and underpinned the credit revolution. Banks are special today precisely because the debts they issue are so liquid that they are accepted as means of payment - money - by other banks (Minsky 1986), in that sense granting them the capacity to issue their debt as money in a similar way the state managed through the Financial Revolution.

It is precisely through conceptualising bank debt in terms of its monetary functions that an understanding can form of the way in which banks sustainably work with liabilities that vastly outstretch their assets, and in that sense function despite being technically insolvent at any one time. Much like the state, banks have amassed debts well in excess of the level where there is any realistic prospect of repayment. Yet the continued ability of their debt to function as money meant that this solvency problem was not as important as managing liquidity. It is for that reason that the interbank money market was crucial, because it provided the constant stream of liquidity necessary for bank debt to work as money.

This is why the idea of deregulation is misleading. Bank debt did not acquire monetary functions by dissolving the monetary infrastructure that was already established. Rather it built on this infrastructure. It is why Minsky placed such importance in the development of the federal funds market whose emergence he witnessed as a participant observer at a major Wall Street brokerage house in the late 1950s (Minsky, 1957; Mehrling, 2015). He describes the period as a crucial turning point in the transition to conditions of 'financial instability' (characterised by rampant credit creation) in the American economy. As came to be the case in Britain, it was the nascent techniques of liability management that drove the transformation. In the postwar era, American Treasury Bills (issued by the state) were the primary instrument through which banks met their liquidity requirements but towards the end of the 1950s banks started to issue their own Certificates of Deposits (CDs), which together with repos, sparked a credit revolution. "Introduced in the banking system in the early 1960s," Minsky later wrote (1986, p. 85), "[CDs] soon became a favourite vehicle for the investing of large-scale holdings of short-term funds. The growth of CDs in the early 1960s enabled bank credit to expand substantially faster than the reserve base."

Minsky's point here is important. The argument implies that before the emergence of liability management through CDs, banks were still dependent on customer deposits or central bank reserves. Under these conditions they were less able to expand their own credit money so rapidly. Instead (whatever the origins of money<sup>11</sup>) banks had to behave much more like the neoclassical model where they intermediate customer saving and investing, and chase deposits to increase their possibility of lending. In these conditions monetary growth therefore comes from within the productive economy (or from central bank diktat) rather than being injected into the economy by bank creation. This actually describes the conditions of nineteenth century England quite well. At that time the clearing banks that dominated grew their deposit base and lent from these reserves (Knafo, 2013, p. 155). Even when the joint-stock banks developed, slowed their use of gold or Bank of England created cash to settle deposits between themselves, and issued cheques drawn against deposits (Chick, 1993), there was still a base to which they were tied<sup>12</sup>. This is precisely why banks felt so compelled to court deposits and expand branch networks, and why the banks with the biggest branches (the Big Five clearing banks) dominated English banking (Nevin and Davis, 1970).

Though by the twentieth century there were multiple forms of money in the British banking system<sup>13</sup>, bank lending was still based on the physical collateral of deposits and state-issued debt established an institutional limit on monetary growth that could not be breached<sup>14</sup>: Though the London discount market was highly

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<sup>11</sup> It is notable, for instance, that in the nineteenth century the dominant view of money creation was that money originated from banks as credit. Henry McLeod is thought to have originated the credit money approach but was speaking to a specifically Scottish context where banks would issue loans as credit secured on land to farmers who would then repay from the spoils of newly created produce. In that sense credit preceded productive output, which was central to the way MacLeod developed his thinking on banking (Skaggs, 2003).

<sup>12</sup> Cheques helped the 'money supply' to grow well in excess of the notes in circulation and the stock of gold but lending was still thought to come out of a fraction of these reserves, with 'deposits' in the banking system as a whole increasing by a factor of 1/reserve requirement (Stiglitz 1997: 736 in Werner, 2015, p. 7).

<sup>13</sup> These included customer deposits, the notes issued by the Bank of England, Treasury Bills issued by the government, and commercial bills of exchange, created by banks themselves (Allen, 2014). Indeed, the money market in Britain was so well developed that the Radcliffe committee (1959, p. 133) could describe there being "many highly liquid assets which are close substitutes for money" which made the control of broad monetary growth difficult.

<sup>14</sup> The monetary authorities could, however, increase the issue of Treasury Bills or Bank of England notes, which would increase the money supply. As I laid out in the

developed, it was not used to issue 'money as debt' for the purpose of retail lending beyond what the (fractional) reserve base would imply (Chick, 1993).

The difference between then and what followed was not deregulation but the fact that bank money became more significant through the development of techniques of liability management. Given its importance, the heterodox literature says surprisingly little about the new developments that took place on the money market in the 1950s and 1960s. To be able to call on the money markets to meet cash commitments the 'asset' side of a bank's business need to be fine tuned carefully enough to ensure a constant flow of cash in, but the 'liability' side requires careful management (Dymski and Pollin, 1992). A bank raising funds from the wholesale money markets is dealing with sophisticated investors who often demand higher interest rates than everyday retail depositors. There also needs to be a money market of sufficient size and depth to be able to handle a bank's varied business. It is hardly a surprise, therefore, that money market "liability management" was not a mainstream strategy for banks for a long time (Nevin and Davis, 1970). Without sophisticated techniques of 'liability management', the credit revolution would not have been possible, and the key question to consider then is how these techniques emerged. While it would be easy to depict liability management as an aspect of 'market governance', where the state stepped back, this would reveal very little about the specific ways in which liability management affected the monetary infrastructure in Britain and the impacts it had on the state's capacity to govern as a result.

In the following section I examine the context in which liability management emerged in Britain. It came at a time when Britain's financial sector was undergoing a significant change through the emergence of a parallel sector that was not directly tied to the governance mechanisms of the Bank of England.

#### 4.2 The institutional origins of the credit revolution

The development of liability management had a transformative impact comparable with the emergence of discounting by the London Goldsmiths centuries before. Precisely because it helped private debt to serve more widely as money, it

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previous chapter this was of course something they often did. But the clearing banks could not of their own accord increase the money supply.

transformed banking and underpinned an exposition in liquidity and private indebtedness that has come to characterise the contemporary economy. Yet the expansion in debt did not take place in an institutional vacuum; rather liability management was born in a highly-regulated American financial context and imported to Britain (Konings, 2011). This came as part of a broader shift in the British financial landscape that saw greater competition and a growing financial market in Britain that was to require a new settlement for financial governance, one that accepted the changed role for government debt securities in the control of system-wide liquidity.

The credit revolution took place through the development of a secondary financial system in Britain that emerged parallel to, and intertwined with, the primary sector that had been established over the previous century. The impacts of this were felt on a number of fronts, mostly immediately by the Big Five clearing banks. The dominance of these banks, whose credit creation was regulated by the Bank of England through discount houses, ebbed away as the secondary market, which operated outside of the Bank of England's sphere of influence, developed (Revell, 1968). The rise of the secondary markets and the arrival of liability management coincided and deepened the decline of the joint-stock banks that had dominated since the 1850s, and helped to establish, for the first time since the Bank of England's imposed monopoly on note issue, the extension of credit to levels well beyond what even fractional reserves would imply. These dynamics altered the terrain of monetary governance, rendering the existing British apparatus incapable of directly controlling credit creation. The deep interconnections between public debt securities and the private banking and payments system caused changes to the way that retail banking worked in Britain. In turn, this had implications for the operation of debt management.

### Challenging the clearing banks

The postwar period of Keynesian experiments in monetary governance originated at a time when the Big Five clearing banks dominated British finance, yet by the end of the 1950s, this was beginning to change. Since the demise of the country banks in the middle of the nineteenth century, the Big Five had dominated the financial sector, with personal and commercial deposits in clearing banks accounting for 80 per cent of the total deposits in Britain in 1951. By 1967, however, their influence had dissolved and the figure had almost halved, dropping

to 46 per cent (Nevin and Davis, 1970, p. 214)<sup>15</sup>.

In their place, a number of new and alternative financial houses began to ascend in the 1950s: building societies, Trustee Savings Banks, hire purchase houses, and international banks (Channon, 1977). These were financial houses that operated either in the mainstream, Bank of England governed primary markets, or, increasingly in the growing secondary market that existed in 'parallel' to the traditional system (Einzig, 1971). The growth of Britain's parallel financial sector can easily seem like an example of financial innovation developing to escape the institutions of monetary governance but such an account would miscast what developed in Britain and the intricate ways in which the primary and secondary markets were integrated.

Initially, the Big Five clearing banks tried to avoid really competing with the new houses. They had an established practice of cartel-like collusion where they offered customers zero interest on current account deposits, and a fixed rate of interest on savings account deposits that was uniform to the sector (Channon, 1977, p. 40). In that sense they did not 'compete' for deposits (liabilities). Neither did they compete on the lending (asset) side of their business. This was because they felt that if any one bank offered more loans than their competitors, it would eventually result in comparatively more claims being made upon their reserves, meaning that cash reserves will transfer to those other banks, the reserve ratio will fall, and the liquidity position become untenable. As a result, the Big Five clearers felt institutionally bound to move together, instead of really competing on credit advances (Macmillan committee, 1931, p. 34) The authorities were happy with this cartel behaviour because it ensured interest rates offered to customers were predictable allowing the Bank Rate to remain fairly stable as it did not have to adjust continually to manage short-term retail rates (Nevin and Davis, 1970, p. 216). This, in turn, meant that longer term yields on gilts would not have to fluctuate (Needham, 2014a). Through the 1950s and 1960s, the Bank of England felt this stability was an important factor in its ability to continually sell gilt-edged securities

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<sup>15</sup> Amalgamations between the retail-facing arms of banks since 1967 has meant the sector is once again highly concentrated today, with the four big UK banking groups: RBS, Barclays, HSBC and Lloyds Banking Group, along with Nationwide and Santander accounting for 80 per cent of the stock of UK customer lending and deposits (Davies et al., 2010, p. 323).

to fund the national debt, which had become a permanent feature of the British economy after the war.

Yet this situation was being made increasingly untenable by the growth of the parallel sector. An important aspect of this on the retail side, directly in competition with the clearing banks, was the growth in personal finance. The postwar boom had brought increasing wages and the development of a consumer spending culture in Britain (which of course was fermented by successive Conservative governments looking to consumers to drive growth). There was a rush in demand for consumer durables bought on credit in the 1950s and this new debt-fuelled consumption opened an avenue for new financial houses to expand (Channon, 1977, p. 49). It was specialist hire purchase houses, rather than the established banks that really drove this market. The traditional merchant banks, who were struggling with the declining use of sterling in comparison to the dollar, did enter some of these areas but at this stage were more focussed on trying to build overseas interests (Jones, 1995), while the big five joint-stock clearing banks seemed to ignore the hire-purchase market altogether (Channon, 1977). They didn't really see the opportunities in consumer credit - the most obvious entry point for them - preferring to stick with their established practice of providing overdraft facilities to corporate clients (Channon, 1977, p. 44). By the end of 1958 hire purchase lending exceeded £600m, most of which was concentrated in a fairly narrow line of consumer goods: motor vehicles, but also furniture, radio and TV sets, gas cookers and refrigerators (Radcliffe report, 1959). The hire purchase houses managed to suck deposits from the mainstream retail banking sector, raising the majority of their funds from industrial and commercial deposits. Yet perhaps more important was their activities on the liability side of their business. They used the money markets to raise a small amount by issuing terminable debentures of three, five and seven years (Radcliffe report 1959, p. 75). Recognising the potential this had to rapidly expand their assets, they they established the Finance Houses Association to lobby the authorities for the right to expand their use of unsecured notes (Radcliffe report 1959, p.76). And it is to this, the developments on the parallel money markets, to which I now turn.

#### Challenging the discount market

The parallel money market was a money market that existed outside the realm of formal Bank of England oversight (Einzig, 1971). Its first flourishing came not

through private sector innovation but rather stemmed from changes in the public sector that owed to concern among Conservative politicians over the scale of the national debt. As I showed in chapter three, the Conservative governments of the 1950s were keen on restructuring the national debt and wanted to loosen the strain government investment placed on the national budget (in large part to allow for consumer-friendly tax cuts which they felt would stimulate growth). For this reason, in 1955 they changed the way local authorities accessed investment funds, increasing the rate at which local authorities borrowed from central government (via the Public Works Loan Board) (Collins, 1988, p. 371). The new rules required local authorities to either borrow from the loan board at market rates or access finance from the private money markets. Local authorities did the latter by issuing securities on the wholesale money markets. Since local authorities were prevented from issuing long-term stock, they instead experimented with trying to raise short-term deposit-like securities at first (Einzig, 1969, p. 106). These were wholesale deposits, issued in sterling, with maturities of between a day and week. In addition, they began to issue large-denomination bills. These securities were mostly bought by clearing banks and other new financial intermediaries, along with some large corporations and even other local authorities (Collins, 1988, p. 371). This had the effect of creating a market in short-term highly liquid securities, which, because they had the implicit backing of the British state, were considered similar to Treasury bonds, but existed outside of the traditional discount market.

In the early 1960s short-term borrowing rates were significantly lower than long-term rates, which meant local authorities found it cheaper to finance themselves through short-term borrowing, and as such the market developed quickly. Indeed, such was the scale of the market for local authority financing, it ended up influencing broad international movements of funds to and from London (Einzig, p. 1971, p. 106). For example, in 1961 Dawney Urban District Council borrowed £232,000 from the Moscow Narodny Bank to finance their housing programme (Burn, 2006, p. 192). In effect central government had been disintermediated and the liquidity that was developing on the money markets was creating an opportunity for local public institutions to access finance. At a time when the national debt was still high, the new local authority borrowing established another aspect to politics of the state's debt. The increase in this 'unfunded' floating debt, driven by the growth in short-term local authority financing, worried the monetary authorities to such an extent that in 1964 the Treasury decreed short-



term borrowing had to be capped at 20 per cent of total debt (Einzig, 1971, p. 108). The public sector was, therefore an important driver in the development of the secondary markets, even a decade before the 'deregulation' of domestic and international finance that much heterodox literature takes as a starting point. This demonstrates how the growth of financial markets came not from dissolving the monetary infrastructure that was in place and mobilising 'market governance' instead, but precisely by using this infrastructure as a base for further development.

By the early 1960s the British secondary money market was largely domestic, made up of local authority finance, and consumer finance through the hire-purchase companies. While this was important in the early reshaping of Britain's financial architecture, it did not as yet pose a threat to the broad system of governance based on Treasury Bills (Revell, 1973). Indeed, the problem of excessive liquidity was still deemed to originate from the overabundance of Treasury bills in the banking system which, as I argued in chapter three, was articulated in terms of the pressure it placed on Britain's external deficits. This is why when Labour prime minister Harold Wilson first came to power in 1964 he was obsessed with trying to improve Britain's exports by remedying the sluggish productivity of Britain's manufacturing sector (Hall, 1986). Yet in the financial sector, at the same time as home-grown outsiders were first making headway into British finance and establishing a secondary sector, American banks were arriving onto the new secondary money markets. It was these American banks, operating in the emerging Euromarkets, that were best placed to capitalise by importing their sophisticated techniques of liability management into Britain (Channon, 1977). The basis of the state's power to govern the economy through its control of government debt securities on Britain's discount markets was undermined by the way American banks used the Euromarkets.

The Euromarkets are now described as one of the most pivotal financial innovations of the twentieth century (Reid, 1988) and the most significant monetary device since the banknote (van Dormael, 1997). That such important innovation took place during the high time of 'embedded' finance is not because regulators lost faith in the efficacy of state regulation and turned to 'market ideology' instead, but is precisely because of the impact liability management had in revolutionising the money markets. Its development came from the way the dollar shortage that had characterised the world economy just after the second world war (and which was overcome by Marshall Aid and the Korean War (Wyn-Jones, 2016)) soon became a

dollar glut as the American economy boomed. The Euromarkets were encouraged by the banking and regulatory communities of London, New York and Washington to become a London-based site for international banks to offer dollar credits on the basis of their non-resident dollar holdings (Burn, 2006; Green, 2016). This was a profitable business that, given the excess of dollars in the international financial system, was easily expanded (Konings, 2007, p. 47).

Initially the Euromarkets were a useful place for American corporations to escape the domestic restriction on interest rates they could earn on their deposits. As such, rather than earn low returns on their savings, they opted to bypass the domestic American financial system altogether and hold their savings on the Euromarkets instead. This disintermediation by American corporations of the American financial system prompted American banks to move into the Euromarkets. With American regulators trying to overcome their own balance of payments problems by restricting the outflow of dollars, the Euromarkets provided American corporations a perfect escape (Konings, 2010). For this reason, the Euromarkets had a powerful effect undermining the Bretton Woods system, long before Nixon formalised its collapse by closing the dollar-gold window in 1971. It was through their operation on the Euromarkets that American banks introduced liability management to Britain and the development of an active money market outside the discount market. American banks had long had better expertise than their British counterparts in techniques of money market liquidity management, because historically American banks operated under heavy restrictions that made it difficult for them to raise deposits (Konings, 2007). Their restricted deposit portfolios meant that during the postwar period they were often unable to meet customer demand. As such, willing borrowers were forced away from banks and had to find alternative sources of liquidity. In early postwar America, corporations relied much more on issuing their own securities directly to institutional investors, bypassing American banks altogether. This 'disintermediation' threatened the position of the American banks and forced them to experiment with techniques of money market deposit raising that characterised the emergence of 'liability management'.

Crucial to this, as Minsky later observed, was the development of Certificates of Deposits ('CDs') which allowed American banks to buy deposit-like liabilities on the money markets and thereby meet their liquidity requirements. It worked by helping to establish a significant market for interbank, short-term securities, which became the basis for liability management. CDs were first created

by Citibank in America in 1961 as a money market instrument that allowed banks to lend to one another (Degen, 1987, p. 131). Specifically, it was a promise that “a certain amount of capital will be deposited with an issuing bank at a specific rate of interest, and that this deposit will subsequently mature and be paid back with interest at a future date no less than three months away” (Channon 1977, p. 11). In a sense they were like a normal deposit but in the context of the heavily regulated US financial markets they were especially useful because they could be tailored individually (Nevin & Davies 1970, p. 230). Though they were not exempt from the interest rate ceiling that existed in postwar America, because they were issued for set minimum periods - and could not be withdrawn at an instant - banks were therefore permitted to offer higher rates than more regular demand deposits. Moreover, as the market grew, banks actively created a secondary market in CDs which allowed holders of the instrument to sell off easily at time of their choosing (Konings 2007, p. 46). This transformed them from time-deposit like instruments into something that resembled demand deposits. That way they were highly liquid (like demand deposits) but were able to offer a higher interest rate and could compete on the money markets with Treasury Bills and commercial paper. The great significance of CDs was they provided banks with a response to disintermediation. Banks could issue CDs on the money markets and sell them to commercial banks. Though not a direct form of corporate deposits into bank accounts it was a money-market form, which rested on the marketability of CDs (Konings, 2006, p. 480).

They changed the way the money market worked. It was not that a money market did not exist before, but with Citibank’s innovation, it became less a place where banks bought financial assets, and instead more a site where banks sold obligations (debt) in exchange for liquidity (Konings, 2006). In doing so it established the possibility for banks to facilitate asset growth in accordance with customer demand, allowing for bank debt to serve as money ‘created’ endogenously. This gradually shifted the driver of bank practice. Previously, “the art of banking consisted mainly of acquiring the composition of assets that would earn satisfactory profits while preserving the liquidity and solvency of the bank” (Degen, 1987, p. 130). The new approach was the reverse. As Chernow (1990, p. 54) writes, “instead of managing their assets on the basis of a given liability structure, the burden of securing the bank’s liquidity and profitability shifted towards the management of the bank’s liabilities”.

## The integration of primary and secondary finance in Britain

In this new context where liability management had granted bank debt with more monetary-like functions and underpinned an expansion in lending, the clearers had initially suffered the most. Their initial refusal to participate in new lending practices had undermined their standing, but their passivity did not last. It was their adoption of American-style liability management techniques that helped mainstream the practice (Channon 1977), and meant there was no prospect for the old framework of monetary governance to cope in a dramatically altered environment.

Having ignored personal credit and hire purchase finance at first, the clearers 'bought' their way into the secondary markets at the end of the 1950s. This process began in 1958 when the monetary authorities allowed Barclays to make a 25 per cent investment in the shareholdings of secondary bank United Dominions Trust and a flurry of merger activity followed. Spurred on by a general bull market in the London Stock Exchange, by July 1958 four major clearing banks had bought stakes in hire purchase companies (Channon, 1977, p.49). Interestingly, and reflecting how removed the joint-stock banks still were from these emerging practices, they were reluctant to get involved in management of the secondary houses they had just acquired, deeming hire purchase lending, and personal finance more generally, a touch too crude for their more traditional sensibilities (*ibid.*). Whatever their misgivings, however, the acquisitions proceeded at a pace. "I was on holiday in Wales at the time," a prominent clearer recalled, "and came back to find the whole bloody lot in hire purchase. They went into it like the herd of Gaderene swine." (in Kynaston, 2002, p. 103). This initial takeover period in finance was vertical in nature, with clearers buying companies involved in leasing, factoring, credit cards, and unit trusts using these lines of higher-interest lending to shore any potential liquidity problems that arose in their main line of business (Nevin & Davis, 1970).

By acquiring stakes in secondary houses, the clearing banks soon developed skills in the liability management that the secondary banks had acquired (Channon, 1977). Nonetheless the British banks were at a disadvantage to their international competitors, because in comparison with American banks especially, but also German and Japan financial houses, British banks were significantly smaller and less capitalised (Goodhart, 1982). Liability management was much more viable when a firm was more deeply capitalised, given the tight-rope it was constantly facing with the need to have liquidity on hand or accessible at any one

time. This concern about comparative size drove a significant horizontal merger rush among clearers and 1968 saw the biggest banking merger in British history between when National Provincial and Westminster - four and five of the 'big five' (Channon, 1977, p. 42) merged. Nonetheless, it took a while for British banks to really warm to the innovation, partly because of the gentlemanly embarrassment with competing for deposits, something which the clearing bank cartel had never really done (Einzig, 1971).

It was not until 1968 that British clearing banks began to issue sterling denominated CDs and by July of that year \$800 million of CDs had been issued (Nevin & Davis, 1970, p.230). CDs were important because they allowed banks to retain part of corporate liquidity that would otherwise be channelled towards competing institutions in the money market. It meant banks could strengthen the liability side of their balance sheet by compensating for shrinking deposits with funds borrowed from the market (Battilossi, 2002, p. 108). They had a transformative impact in the way British finance moved away from sectoral specialisation, which had characterised the City for generations, towards more universal, investment bank-like activity (Davies et al., 2010). For example, clearers began diversifying their products, offering export finance, foreign exchange facilities, trustee facilities; all practices learned from American banks.

The importance of private sector debt securities in the money market was not new, before the rise to prominence of Treasury Bills after the first world war, commercial securities, in particular bills of exchange, were the main form of discount market liquidity (Revell, 1968). Yet bills of exchange were at least self-liquidating. What started with Treasury Bills and now extended to the private sector with commercial debentures, local authority bonds and most crucially CDs was liquidity being secured on debt-based IOUs, as such stretching the distance between financial sector securities and any underlying 'real' economic activity (Mehrling, 2010). As I examine in the following section, this was to have important implications for the changing way government debt securities fitted within the infrastructure of credit relations.

#### 4.3 The public governance of private money

The expansion in credit that accompanied the credit revolution increased the size and significance of the financial sector in Britain (Alessandri and Haldane, 2009, see footnote 9). This growth did not take place through the dissolution of an

institutional infrastructure, or in abstraction from it, but rather was forged onto the monetary system that had been established over the previous centuries. In outlining how liability management came to Britain, I demonstrated specifically the importance of liability management in establishing monetary features to bank debt. It allowed banks to greatly expand their role in the monetary system. The credit revolution showed again how when the monetary aspects of debt are taken into consideration, debt is no longer necessarily a problem to be avoided, something that drags on productive life, and which, unless paid back swiftly, courts financial (and ethical) ruin. Rather it showed how the ability to create debt (as money) could be incredibly productive. Because the credit revolution was a private-sector development, it was harder to account for its effects on public debt and public governance. As I have mentioned, it is often assumed that public governance was overwhelmed and the state stepped aside to allow for market-rule instead, which deepened the power of creditors over all other social actors (for example Nesvetailova, 2010; Chick and Dow, 2013). Yet examination of the specific changes to the money market reveals a different story. It is fair to say public governance was transformed, but the capacity of the state to govern was not diminished.

The transformation was clear. The state's ability to govern the economy through shifts in liquidity stemmed from its status as near monopoly provider of the two dominant sources of banking sector liquidity: banknotes and, more significantly, Treasury Bills. Yet the growth of CDs and interbank lending through liability management rapidly changed this. Treasury bills had made up 67 per cent of total short-term sterling instruments in 1957, but by 1979 accounted for just 6 per percent (Collins, 1988, p. 361). This decline began in the 1950s and 1960s as alternative sources of liquidity, originating from outside the monetary authorities' influence, developed in the Euromarkets and the secondary banks and local authorities. As such, much as the excess of Treasury bills had curtailed hopes of traditional monetary policy in the mid 1950s, the result of liability management was that the monetary authorities faced the reverse problem, with Treasury bills too insignificant a part of the money market to be useful in the direct control of liquidity. This had implications beyond even broad monetary governance and actually affected the working of the clearing bank cartel itself. The secondary houses often offered better terms on deposits and this led to a reduction in the Big Five clearing banks' share of total deposits (Channon, 1977). Unless the cartel ended, and banks

were forced to compete for deposits by offering higher rates to savers, the 'disintermediation' of the traditional financial system would continue. In turn this worsened the dynamic of broad monetary governance because fewer deposits and loans were being made out of the system where Treasury bills were significant.

The result of which was that the state faced two key problems: First was how to stem disintermediation of the clearing bank sector; second was how to make monetary policy effective in a context when public debt securities were no longer the main form of liquidity in the banking sector (Revell, 1973). More broadly, by the late 1960s the monetary authorities were beginning to operate in an environment where there appeared to be no possible restriction on credit creation. This was because of the growing prominence of securities like CDs that were neither rationed by the state nor self-liquidating and corresponding directly to contracts in the 'real' economy (Degen, 1987). In order to solve the two problems I identified, and govern liquidity, the state needed to be able to act on a banking system that organised its own operations in terms of the necessities of liability management. The issue of what monetary governance looked like in conditions of unlimited credit was to become a pressing problem which initially, as I examine in the next chapter, led to all kinds of misguided attempts with 'monetarist' control of the money supply. These regulatory reforms that were to take place in 1970s came through an attempt by the public authorities to control, guide and govern these new monetary dynamics, rather than simply 'enable' them because of an ideological faith in market governance or because newly-empowered creditors imposed their will over policymakers. The changes that had taken place transformed the way banking operated. Broadly whereas previously banks operated by expanding their deposit base before expanding their lending, now the reverse was true. Banks could secure funds to meet their asset growth by issuing financial securities that had very low or no reserve requirements. Governance in this context was very different because the Treasury Bills mattered less and reserve requirements were insignificant. As Early & Evans put it (1982, p. 55) liability management broke "the three-way link that once connected the volume of bank reserves (monetary base); the volume of demand or checkable bank deposits (money) and the level of bank lending."

It was a rapid transformation as well. The first sterling CDs were issued in 1968, a year later total holdings stood at £442m and by 1971 it had grown to £2242m (Revell, 1973, p.280). Their growth was due to the way banking based on liability management worked. Banks extended advances not through the traditional

overdraft manner that had long characterised British banking - and was still the norm for clearing banks at the start of the 1970s - but through fixed-term loans. Such advances were less suited than overdrafts in the provision of working capital, but chimed well with needs for longer-term investment projects, in particular property-development and construction where the use of new investment appraisal techniques like Discounted Cash Flow were more common (Miller, 1991). In this way liability management-based banking, which characterised these secondary banks had large fixed-termed accounts on both sides of the balance sheet, all repayable at knowable but varying points (Revell, 1973).

The key to managing a successful banking operation in that context was not controlling for liquidity in the traditional sense (guarding against a sudden mass withdraw of deposits), but about trying to 'match' the maturities, interest rates and exchange rate terms of a bank's assets and liabilities (Revell, 1968)<sup>16</sup>. In this type of 'matching' model of banking based on liability management, interest rate changes (and expectations of them) are even more significant than in the traditional model (*ibid.*). An expected rate rise means bankers will have their assets short as possible and liabilities long as possible - they can switch into higher yielding assets when the interest rate change comes, but continue to pay lower rates on a high proportion of liabilities, and vice versa. Given that secondary banks dealt with large accounts, usually £50,000 on either side of balance sheet, and given that such opportunities are rare but always taken, to maintain a 'match' they cannot rely on the customer base to readily draw on deposits (Revell, 1973, p. 247). The result is that they have to turn to each other on the interbank deposit market for fulfilling their matches, or else by issuing CDs. This is precisely why the market for CDs grow so rapidly. Key to his growth was the way in which a large secondary market in CDs was established, because this ultimately allowed CDs to resemble the liquidity of demand deposits. Interestingly, the secondary market for CDs was actually forged around the backbone of the mainstream money market, the traditional discount houses. Demonstrating how interconnected the traditional and parallel markets really were, the discount houses were the dominant market-makers of CDs. By 1971 they held between 89 per cent and 93 per cent of all sterling CDs (Revell, 1973 p. 277) in their role as dealers on the secondary market. Because they act as principles, their profits stem from dealing, and as such they

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<sup>16</sup> Revell (1968) was on of the first statements on the process of matching in the UK.



held a larger book when interest rates were expected to fall and reduced their holdings when rates were expected to rise. The discount houses' significant participation in the secondary CD market posed an interesting governance problem: CDs were not eligible collateral for loans from the Bank of England, which meant the discount houses were compelled to borrow from the interbank sterling market when running short of the cash needed to fulfil their traditional role of extending liquidity to the clearing banks.

What is striking is that the parallel market worked in a manner seemingly entirely opposite to the traditional discount market. All loans were unsecured interbank loans, there was no direct intervention by the authorities and no established principle for a lender of last resort (Revell, 1973, p. 270). To compound the risk of unsecured lending was the fact that the network of interbank deposits meant that lending banks had no control over the ultimate destination of the loans they advanced (Revell, 1973, p. 286). If this implied a general riskiness to the sector what posed further problems for the monetary authorities was that interest rates on the interbank money markets were - for the reasons I mentioned - much more volatile than on the traditional discount market. Given the absence of a Bank of England decreed ceiling on terms of liquidity, overnight rates could vary from 1 to 100 per cent. Moreover, the growing size of the interbank borrowing market meant that these volatile rates were more significant than the controlled and stable Bank Rate. As Revell wrote in 1973 (p. 273): "Up to a few years ago it was usual to talk of Bank Rate or the treasury bill rate as determining other rates, but for the past three or four years it has been the inter-bank sterling rate for an appropriate maturity which has come to represent the 'cost of money' in London."

At the start of the 1970s, then, the monetary authorities faced problems on a number of fronts, all of which stemmed from the fact that the primary discount market was being bypassed as a result of the credit revolution. There was the basic problem of excessive credit creation that was heaping further pressure on sterling (Schenk, 2010). There was the emerging and seemingly unknowable systemic risk through a network of interlinked, unsecured interbank loans. There was significant interest rate volatility on the parallel money market, and a significant divergence between its interest rates and the Bank Rate which applied to the traditional discount market (Revell, 1973). Given the way that short-term rates affect long-term rates, this meant interest rate volatility on the gilt markets; something the Bank of

England had always tried to control for by 'leaning into the wind' of the market (Needham, 2014a).

These multiple and specific issues are only made visible by departing from the framework of thought that sees the credit revolution in terms of the establishment of market-led governance. Moreover, when the credit revolution is conceptualised in terms of the institutional infrastructure required to facilitate expanding credit, it becomes possible to see what new avenues for governance were opening up for the state. If the rates offered on 'parallel' markets could be connected to the traditional discount market, then the state would be in possession of an even more powerful transmission mechanism to guide systemic liquidity.

Moreover, in a highly leveraged money market, where banks drew upon an interbank market whose unsecured deposits were only as liquid as market sentiment decreed, the importance of government securities as a guarantee of high-quality liquidity only grew. Government debt would become less called upon as a source of liquidity in normal times, but presented a very solid collateral on which to secure further money market liquidity. This was something Minsky (1986) had recognised in the emerging federal funds market when he described state debt as standing at the apex of the credit pyramid, but was not yet something policymakers in Britain had conceptualised. Instead, as the monetary authorities strived for a new settlement of governance to fix the problem of discount market disintermediation, they undertook a series of ill-judged experiments to control the credit revolution through ideas associated with monetary control.

## Conclusion

The period surrounding the early 1970s has come to be cast as crucial in explaining the development of Britain's highly-leveraged, debt dominated political economy. Many see the growth in private sector credit creation as the start of a move to private, market-led forms of monetary governance. The fact that private banks had the capacity to use their debts as a form of money is now often taken for granted. Yet in providing a historical overview of the key developments in Britain's postwar financial sector, I tried to show how it was that private debt acquired monetary features. Liability management was central to this and its arrival in Britain was a part of a number of changes to the British financial landscape.

In historicising the credit revolution like this I show how there was no straightforward 'marketisation' of British finance which developed in place of the

Bank of England dominated institutional landscape. Rather, the parallel sector and techniques of liability management were grafted onto what was already there, creating problems for both the well-established clearing banks and the monetary authorities. Specifically, I showed how the practice of liability management transformed the logic of banking, where previously banks lent to customers before raising the assets to match on the open money markets. This helped generate an explosion of liquidity that had profound effects on the ability of the monetary authorities to curtail credit creation.

In outlining this private sector history, this chapter provides a context through which to examine how the debt politics of the 1970s and 1980s played out. In the chapter that follows I explore how the attempt to achieve 'monetarism' was thwarted by the rise of liability management, while at the same time the ambition to squeeze the money supply ended up making the 'gilt market' a coherent force in a way that had not been the case previously.

## 5. Monetary targets: Depoliticising governance?

### Introduction

Monetarism was a technical theory about economics that became charged with political symbolism. Formally, it was the argument that inflation was caused by an excess creation of money. Yet the ideological implications were stark. Because underpinning the monetarist theory was the idea that “excessive” democracy was the heart of the inflation problem. As the arch monetarist Samuel Brittan (1975, p. 130) argued in his famous polemic *The Economic Contradictions of Democracy*, unless government found a way to check the “excessive expectations” generated by what he described as the “democratic aspects” of the political system, uncontrollable inflation would follow. In the mid 1970s when the credit revolution had combined with the oil price crisis to hike up inflation across the developed world, Brittan argued that the future of the United Kingdom as a functioning liberal democracy was in doubt.

The monetarist case of writers like Brittan, and his Cambridge professor Milton Friedman, was forged on a recognition that public debt came with monetary implications. If a government’s debt could be printed as money, it followed that the Keynesian inference was right and there was, indeed, no fiscal perimeter to the amount of debt a state could issue. There was, as such, no limit on what a government could spend. For monetarists this meant that when politicians were pushed by democratic forces to placate their subjects with greater spending, they would turn inevitably to the printing press. On this basis monetarists argued that liberal democratic governments like Britain faced a trade off between monetary stability and economic democracy, and if the latter was not contained, crippling inflation was inevitable.

This monetarist framework became an incredibly powerful lens through which to read developments in monetary governance in Britain over the 1970s and 1980s. The emergence of monetary targets was seen by monetarists as the solution to the problem they laid out, because it bound the scope of government policies within parameters that would ensure against excessive money creation.

Following this framework many critics (for example Burnham, 2007) now depict monetarist reforms as a 'depoliticisation' of monetary governance in Britain. Indeed a mirror image of the monetarist trade-off between debt and democracy is present in Wolfgang Streeck's (2014a; 2014b; 2015) argument about the politics of the 'debt state'. For Streeck, governments dependent on credit must always take steps necessary to establish credibility in the eyes of international investors. These steps might be at odds with the wishes of the general populace, and as such it could be necessary to protect economic policy from democratic influence; to 'depoliticise' monetary governance.

I argue that the notion of depoliticisation misconstrues the significance of the changes made at the time and the character of contemporary governance today. It is a notion anchored in a monetarist framework of the politics of public debt, which makes even critical writers depict monetary targeting as a strategy of market credibility that succeeds by using 'rules' and targets to limit the state's room for manoeuvre (Flinders and Wood, 2016). From this perspective, depoliticisation involves devolving governance from the state to the private sector, and establishing a technocratic form of rule sealed off from the formal channels of democratic influence (Gane, 2015). The idea being that 'targets' and 'rules' bound economic policy within an explicit framework, and thereby act as a check on the democratic impulses that the likes of Brittan had warned against.

In tracking the emergence of monetary targets in Britain I show how, whatever the rhetoric, monetarism and the idea of market-regulated credit only ever figured as an aspiration. Indeed, the targets themselves were routinely missed. Though the depoliticisation literature, like the monetarists they critique, placed great significance in the targets, what mattered more was what was constructed in the effort to make the financial sector behave like the monetarist ideal. As I will show, the attempt to govern through 'targets' resulted in complete overhaul of the way the two key instruments of government debt, Treasury Bills and gilts, were managed. Yet the state did not simply dismantle and box away its tools of liquidity management to pursue 'depoliticised' governance. Rather the monetary authorities' experiment with targets was an attempt to find a way to respond to the credit revolution and regain control of liquidity. Through the chapter I outline how the period is best understood as an attempt to build the capacity for interest rate control of the broader economy. The unexpected result of which was to end up placing enormous pressure on the gilt market. As such, the effect of the monetarist

revolution was not to depoliticise governance and eradicate the state's capacity for discretionary intervention, but to transform it in important ways that was to later enhance the ability of the state to govern through debt.

The chapter is divided into four sections. In the first section I examine in more detail how depoliticisation became a dominant frame for thinking about monetary governance since the onset of monetarist thinking, and how the notion is too broad to capture what was really at stake in post 1970s governance. The second outlines the workings of the gilt market in postwar Britain before tracking how the debate on monetary targeting first came to Britain from the IMF in 1967. As a condition for the financial support they provided after the devaluation of sterling, the IMF stressed the need to control what it called Domestic Credit Expansion ('DCE'), an imperfect measure of credit creation. This first experiment in targeting proved crucial in establishing an intellectual platform for what followed in the 1970s. The third section then examines the second attempt at monetary control, which came through the 1971 Competition and Credit Control ('CCC') policy. The policy aimed to tackle the problems the credit revolution had created for monetary governance by deregulating the 'primary' sector and attempting to govern the banking system as a whole. This meant swapping 'direct' controls on individual banks for a more broad-based interest-rate based management that would keep growth of the broad money supply, £M3, in check. As I show, the policy was a spectacular failure on its own terms, but did remake the gilt market by removing the Bank of England's support. Finally, the fourth section examines the third attempt at monetary control, with Margaret Thatcher's Medium Term Financial Strategy ('MTFS'). I show how the framework was internally incoherent - the targets were set arbitrarily and routinely missed - and how the attempt to govern through it brought a significant recession and was soon abandoned. Nonetheless, it heaped more pressure on the operation of the gilt market which by the early 1980s was in need of major reform.

### 5.1 Who will guard the printing press? The politics of depoliticisation

The difficult relationship between the state and public debt is often thought to have reached a tipping point in the 1970s (for example Streeck, 2014a; Buchanan and Wagner, 1977). There is an idea that state debt had grown to such excess that, when allied to the global economic downturn of the time, a correction was inevitable. This is why the period is widely thought of as marking an important shift

in economic governance. The postwar era, where government officials saw themselves as the breadwinners of the economy, was creaking and in its place a new order took form. Central to the way this new order is conceptualised is the idea that it was becoming ‘depoliticised’ in some sense: handed over to ‘technocrats’ who have stepped away from normative questions of distribution and shielded themselves from democratic oversight (Davies, 2014). The ‘depoliticisation’ framework has become an incredibly powerful lens through which to conceptualise contemporary governance and deeply implicates discussions of neoliberalism today<sup>17</sup>. Yet as I argue in this section, depoliticisation is a very loose idea that is built on normative assumptions about the unsustainability of debt and the problems it presents democracy. Depoliticisation risks an overly functional explanation of the governance changes that have taken place since the 1970s, presenting ‘rules’ and ‘targets’ as bulwarks against the kind of politicised governance that would risk violating creditor interests. In that way the notion of depoliticisation relies on the idea that excessive public debt allowed creditor interests to squeeze out democracy, leaving the instrument of the state at their behest. Ultimately, depoliticisation is an account of governance being devolved to financial markets at the expense of the state.

As I have asserted throughout, there is more to debt politics than the imperatives of creditors. This is especially true of the way that monetarist ‘targets’ became part of the governing apparatus of the British economy. When viewed through the lens of depoliticisation, monetarism becomes a general, pro-finance ideological move. Yet this has both substantive and conceptual problems. Firstly, it places undue importance in the targets themselves, which were in fact set arbitrarily and also never really met (Cobham, 2003, p. 48). Secondly, it reifies creditor power by depicting the creditor imperative as the overriding principle of debt relations. This inhibits examination of what was constructed through the attempt to establish monetarist-style governance, and how it was not solely creditors having their way, but also affected the capacity of the state to use public debt securities to manage liquidity in the economic system.

Peter Burnham’s work on postwar monetary policy (2007; 1990; 2011; 2014) is a good example of how the notion of depoliticisation is forged on the problematic

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<sup>17</sup> William Davies (2014) for example has described neoliberalism as the displacement of the political by the economic.

idea of debt unsustainability. His work on the financial reforms of 1970s Britain established depoliticisation as a lens through which to read governance changes, with the establishment of a framework of rules and targets that “diminish politicians’ discretion” (Burnham, 2011, p. 464). In his account, and in accounts by those who have since adopted his framework, depoliticisation is depicted as a “narrowing of the boundaries of democratic concern”, closely linked to “the emergence of technocratic and post-democratic forms of governance”, which “deny political contingency”, “transfer functions away from elected politicians” and insulate decision making processes from democratic oversight (Flinders and Wood, 2014, p. 135). Within this general framework Buller and Flinders (2006) identify three mechanisms of depoliticisation. First, governors can seek institutional depoliticisation by establishing third-party bodies that enjoy day-to-day managerial control of policymaking. Second, rules-based depoliticisation is achieved when governors adopt explicit rules that constrain the scope and need for political discretion. And finally, preference shaping depoliticisation, which occurs when governors mobilise ideological or rhetorical claims to lift a certain policy out of the scope of democratic deliberation.

The 1970s monetarist push contained elements of all three. Though the Bank of England was a nationalised body, informal control for setting the Bank Rate had long belonged to unelected Bank officials. More importantly in the 1970s fixed rules were established for monetary growth aggregates. Finally, to some extent the ‘crisis of inflation’ was talked up as a master narrative to frame the pursuit and necessity of policies pursuing monetary targeting. Such depoliticisation was supposedly present in Ted Heath’s 1971 experiment with the ‘Competition and Credit Control’ policy and the ‘Minimum Lending Rate’ reworking of the market for Treasury Bills that followed. Burnham (2007) argues that these were attempts to establish ‘fixed rules’ for governance, over and above the ‘discretion’ of politicians accountable to the electorate, a move he argues that has a lineage back to the Gold Standard and also the Treasury View<sup>18</sup>. Given this long history, Burnham actually warns against the simple periodising apparent in some critical literature (for

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<sup>18</sup> A contemporary example of this would include the 2015 UK Conservative government’s attempted ‘fiscal charter’ that compelled government to achieve a surplus on their budget by 2019/20, and then keep the budget in surplus each year thereafter.



example Chick and Dow, 2013; Nesvetailova, 2010) that sees monetary governance moving from a politicised postwar environment to a depoliticised neoliberal age. Instead, he suggests depoliticisation/politicisation is better conceived of as two poles of statecraft that policymakers constantly oscillate between. Despite the assertion, however, it is not clear Burnham himself avoids this pitfall. Different periods, he says, see more or less politicisation, and he argues - in the keeping with conventional critical literature - that 1970s monetary control was a key moment in changing the emphasis to depoliticisation (Burnham, 2011, p. 464). Burnham draws from Greta Krippner's (2007) call to examine how state officials use markets for the purpose of governance, and both depict the monetarist turn in economic governance as an attempt by state authorities to withdraw from exercising 'discretion', and sidestep normative and distributional consequences of state action, "effectively depoliticising economic policy by redefining economic events as the product of "market forces" rather than the activities of state officials" (ibid., p. 479). Moreover, this seeming 'distance' from democracy is emphasised in the way policymakers discuss monetary matters. As Krippner writes (ibid., p. 483) monetary governance is articulated in a vernacular of technical expertise that shrouds policies in highly inaccessible jargon.

Given the devolution of monetary governance to technocratic institutions, the language of 'experts', the appeal to rigorous 'rules', and the strength of the counter-inflationary narrative, it is understandable that critical literature sees 'depoliticisation' in changes made to British monetary management in the 1970s. Moreover, given Britain's long history of debt-based governance - and the enduring association of Britain with 'liberal governance' (Knafo, 2013) - depoliticisation seems a particularly fruitful concept for examining British political economy.

Nevertheless, to speak about depoliticisation is to speak about a particular kind of state governance - a particular kind of state power - and what this is is never really explained in the depoliticisation literature. Instead I argue that, depoliticisation works as a very general idea, and is presented as a strategy of governance where the state devolves its power to markets, in a manner that resembles Streeck's (2014b) notion of 'market justice' triumphing over 'social justice'. This is because the authors like Peter Burnham that focus on rules and targets as aspects of 'depoliticisation' end up conflating two related issues. The first is their argument that depoliticisation is a strategy to absolve policymakers from the consequences of their decisions. The second is their argument that depoliticisation is a strategy for

market credibility. In their accounts, it is the latter that works as the true driver for depoliticisation. Burnham, and others that draw from his framework, argue that depoliticisation is a strategy that “seeks to change market expectations regarding the effectiveness and credibility of policymaking” (Burnham, 2001, p. 127). The idea being that if you establish rules you can convince ‘markets’ that there will be less space for “political choice or discretion on the part of politicians” on the basis that “the less the need for discretion, the less the danger of policy mistakes being made” (Buller, 2003, p. 7). This is again founded on the assumption that the instability of the state’s debt renders it forever vulnerable to creditors and makes certain policies untenable. It is this form of ‘depoliticisation for the markets’ that drives the others. The more politicians can seal themselves off from the consequences of their policies, the less they can be blamed for what (it is assumed) will be the necessary deflationary procedures that ‘markets’ dictate. This in turn bolsters the supposed credibility of a government’s commitment to undertake creditor-desired programmes.

The depoliticisation literature does not specify what policies creditors desire or why their interests would suddenly take precedence in the 1970s, or how the ‘rules’ for monetary governance that took hold in the 1970s translate into creditor dominance. In this way it overplays the coherence of these rules and, indeed, policymakers’ commitment to them. The inconsistency, and indeed outright incoherence, of monetary targeting as an ‘expert’ framework for policymaking in Britain, for example, was keenly felt in the fact that experts could never agree on what counted as ‘money’ and what policies worked to control its supply (Cobham, 2003). Moreover, even when targets were agreed they were set inconsistently and routinely missed.

This should call into question the efficacy of seeing these rules, and the technocrats that developed them, as significant in and of themselves. What is more important is what gets constructed through them, what institutions are developed, what linkages made; but these are issues that are flattened under the term ‘depoliticisation’. The importance of these aspects are occluded because of the idea that, ultimately, depoliticisation is something that emerges as a necessary step of achieving credibility in the eyes of financial markets. If the entire purpose of monetary governance is to secure credibility, then the state as a debtor is necessarily subjugated to the domination of the market (of creditors). This perhaps speaks to Burnham’s broader research agenda that is dedicated to examining the

efficacy of the state under capitalism (for example Bieler et al., 2006). Undercutting his account is the view that the crisis of capitalist overproduction in the 1970s was forcing the state to pursue deflationary strategies (Burnham, 1999, p. 45). In that sense, whatever the minutia of policymaker actions, there is a deeper driver always lurking in the form of capitalist imperatives. As such depoliticisation can be seen as symptomatic of the state's relinquishing of control and ultimate impotence in the face of the demands of the capitalist market.

On the contrary, in what follows I show how regulatory reform came from an effort on the part of state officials to respond to the credit revolution. Monetarism as an intellectual movement first found prominence in this context. Similarly, when the state undertook programmes of monetary targeting it did so in an attempt to mobilise some particular market actors - notably the clearing banks - in the hope of disciplining others - the secondary houses in particular. In the effort to make monetary targeting successful, the role of government and private debt securities in governance changed. Crucial in this was, I argue, the gilt market, which came to bear a particularly large burden, and made the question of interest rates and interest rate expectations a more important lever of liquidity governance than ever before. When the assumption of debt unsustainability is dropped, depoliticisation no longer captures the significance of the 1970s governance reforms. Instead, as I demonstrate over the remainder of the chapter, it is developments in the gilt market that matter more.

## 5.2 The first target: Domestic Credit Expansion

The problem with depoliticisation as a framework through which to understand monetary governance is that it is overly general and overly functional and cannot account for the specific issues state authorities were confronting. Instead, in keeping with the broader way in which debt politics is often conceptualised, depoliticisation is presented as a strategy to improve credibility in the eyes of creditors, whose imperatives seem to trump all others. I argue it is more fruitful to contextualise debt politics within the monetary infrastructure that issuing public debt as money had established through the previous centuries. This casts the emergence of monetarism in different terms. It can be viewed less as an ideological project that tried to mask regressive or creditor-friendly policies in a veil of objective targets, and more as a renewed attempt by the state to improve its capacity to use the monetary infrastructure to govern liquidity, which in the process radically

reformed the operation of the market for its own debts.

This is because in the late 1960s British policymakers faced a series of interlinked problems, all of which implicated how public debt securities were used to govern the economy, but which cannot be understood solely in terms of the abstract imperatives of creditors. The first problem was the familiar issue of balance of payments. Britain's struggling industrial sector was unable to deliver sufficient exports to keep the balance of payments in check, which meant the Bank of England was constantly fighting to maintain sterling's (overvalued) status (Cairncross, 1995). Second was the credit revolution that broke the transmission belt of monetary policy by disintermediating the traditional discount market. It meant the Bank Rate was no longer setting the 'price' of liquidity, meaning the monetary authorities had little oversight of a substantial amount of lending, plenty of which was 'leaking' into imports, worsening the balance of payments again. Third was the scale of the national debt. Britain had long since carried a large national debt and by 1968 it totalled £34.19 billion, substantially more than the £10.7 billion sterling deposits in the clearing banks (Goodhart, 2014a, p. 124). Such was its volume it was termed 'The Flood' by Brian Tew, one of Britain's leading monetary economists in the pages of *The Banker* in 1969 (*ibid.*). In isolation any of these issues may have been manageable but their combination meant policy fixes were contradictory. This push for monetary targeting came from an incapacity of the state's governing apparatus and as such in revisiting the emergence of monetary targeting and the regulatory changes that it led to, I suggest their aim was not to abdicate control and hand it over to financial markets, but instead the very opposite, to improve the capacity of the state to better control the financial sector.

The three issues first came together in the 1967 sterling devaluation and culminated in the CCC policy four years later, and in the process radically changed the mechanism of economic governance by drawing monetary targeting into the equation. It is notable that monetary targeting was first tasked with tackling balance of payments problems, rather than inflation with which it later came to be associated (Kenway, 1994). In keeping with the postwar arrangements, the initial push for monetary targeting was directed specifically at containing consumer imports, and, unlike the use of narrow monetary targets in other countries like America, began with targets on a very broad calculation of DCE (Needham, 2014a).

The arrangement monetary targeting was seeking to replace was a monetary governance regime aimed at managing general liquidity quite loosely. To

move from an arrangement like this to one that focused on specific targets for monetary growth, in the belief that this could govern the entire economy, required the construction of a significantly different intellectual and institutional policymaking apparatus. In the examination of how monetary targeting was established I argue that what was constructed is not captured by the idea of depoliticised governance, but rather a changed role for public and private debt in monetary governance, and an emerging contradiction between the attempt to secure price stability on the gilt market while at the same time dampen liquidity in the banking system. This becomes clear by examining how the gilt market operated and how it was affected by monetary targeting.

### The gilt market in postwar Britain

To recall, the gilt market is the market for long-term government debt in Britain. It forms the main proportion of government debt financing (Abbas et al., 2014, p. 11)<sup>19</sup> and could be crudely distinguished from Treasury Bills by being thought of as a state's 'mortgage' debt, compared to the 'overdraft' debt of Treasury Bills. Though other instruments existed (such as national savings), gilts were the Bank of England's primary mode of meeting its key remit: the stability of government financing. This stability, it felt, stemmed from gilts remaining highly marketable (Needham, 2014a). This is because the long-term investors who bought gilts, like the pension and insurance funds that had grown substantially since the 1950s, bought them primarily as a safe store of long-term value (Goodhart, 2014a). Yet long-term investing did not actually mean holding gilts until maturity, but rather constantly updating an investment portfolio by selling gilts on before the cash dividend became available and 'switching' to a new gilt (Thomas, 1986). The problem for the monetary authorities was that they could never be sure that a market for switching in this way would exist. The Bank was particularly doubtful because they were convinced gilts were inherently unstable and "driven by 'extrapolative expectations' where 'higher interest rates would create the expectation of yet higher rates", and vice versa (Needham 2014, p.17), and undermine the stability of the gilt switching market as a result. To compensate, the

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<sup>19</sup> In Britain and across OECD countries long-term public debt, like gilts, made up the majority of public debt financing until the second world war. After the war, short-run securities grew in use, but from the 1970s the trend was reversed and long-term debt is now considered to be most desirable (Abbas et al., 2014).

Bank acted to continually influence and stabilise gilt prices, precisely because it saw volatility as being hard-wired into the market and a threat to stable government financing.

The Bank of England achieved this by acting as a 'dealer of last resort' in its own securities (William Allen, 2015, p. 2). Gilts were sold at tender but underwritten by the Issue Department at the Bank of England, which as a result was the main buyer at tender. This provided the Bank flexibility, because it would then sell the majority of the gilts to external customers on the secondary market on 'tap' at a set price. These secondary market transactions took place exclusively through the London Stock Exchange at the behest of the Bank and through the Government Broker, Mullens, who had held the role for over a century. The Bank was prevented from dealing directly on the Stock Exchange because that was a privilege only open to members of which it was not. The Bank of England was not the only dealer in gilts, some discount houses also operated in the secondary market on the London Stock Exchange, but they were very small in comparison (William Allen, 2015). The Bank of England's dominant role in this regard was not by design. Rather, the private sector simply lacked the capacity to underwrite and deal the entire gilt market because of just how big the market had become after the war had expanded government debt (*ibid.*).

Nonetheless by virtue of the arrangement where the Issue Department was the main initial buyer of gilts, the Bank was able to intervene by buying back gilts from external investors on the secondary market to facilitate 'switching' (Thomas, 1986). Despite the long-term nature of both gilts and, in general, gilt investors, liquidity was still therefore an important criterion. Though the Bank was the primary dealer it was still imperative for government financing that secondary market jobbers had the capacity to buy and sell large quantities easily, which is why the Bank acted as a buyer of last resort. This key line of support allowed jobbers to meet investors' constant demands (for switching maturities, interest rates and so on) and was something the Bank felt broadened the market and made gilts more attractive to investors (*ibid.*). The Bank's interventions to facilitate 'switching' also gave it a capacity to influence prices. If the Bank felt investor confidence was weak, it would buy up a load of gilts and edge prices up. In turn, when the market was strong, it would try to sell more gilts to edge prices down. Any gilts issued, but not required by investors, were taken back by the Bank's Issue Department for later

sale (ibid.). As Tony Coleby, head of the Gilt-Edged division at the Bank, later summarised (quoted in LRS, 2006, p.6):

“The Bank stood ready each day to buy a limited quantity of stock at set margins significantly below that day’s opening level. The jobbers could trade in the knowledge that they had some degree of stock loss fallback, but it was limited in amount and expensive to use if they had bought stock close to the opening prices so they would only buy stock close to the market and, in that way, support a wider market if their commercial judgment was that there would be two-way trade at that level.”

It was a system that worked smoothly as long as new issues were infrequent and price levels reasonably stable, and it was the handle through which the state had the capacity to manage its own debt without resorting to what the Bank described as a less preferable option of more “arbitrary and capricious intervention” that could “alienate the larger investor from the market” (in Thomas, 1986, p.61).

Nonetheless, this was arrangement that had developed before any notion of monetary targeting existed in British policymaking circles. And the Bank’s indirect intervention in the manner described above actually had contradictory implications for the objectives of monetary control. This was because at the very moments when aggregate demand was strong and the authorities might want to check liquidity growth through selling gilts to the private sector, gilt prices would be falling (due to inflationary expectations) and sales difficult to achieve. In its capacity as a primary dealer in gilts, the Bank of England often rectified this problem by supporting the market itself, which meant buying back gilts - an illiquid asset - with cash (Needham, 2014a). As I show this meant that the Bank of England was often injecting liquidity into the banking system at the very time when the monetary authorities were trying to restrict liquidity growth. This contradictory dynamic becomes apparent by examining how monetary targets were forged onto the governing apparatus that was already in place.

### ***Integrating ‘money’ into Keynesian governance***

The notion that growing state debt eventually courts a crisis of sovereignty is present in the way monetary targets are deemed a form of ‘depoliticised’ governance. And indeed targets were first introduced at the behest of the IMF when Harold Wilson’s Labour government was forced to borrow from them in 1967. Yet I argue here that their significance lay not in the way that targets narrowed the state’s room for manoeuvre but rather in the way they ended up, eventually,

increasing the importance of the Bank Rate whose significance had been dented by the credit revolution. This becomes clear by contextualising how monetary targets fitted in the broader institutional infrastructure of the British monetary system, transforming the operation of the gilt market that I described above.

Wilson had come to power in 1964 and sought to manage the banking sector more directly than his Tory predecessors (Hall, 1986). At that time, the monetary authorities did not see monetary targeting as a viable policy option. This was because for money to be controlled, first it had to be counted, and the monetary authorities felt this was impossible. The 1959 Radcliffe report, that was commissioned after the failure of 1950s monetary policy, reasoned that there were too many money-like assets in Britain's financial system to have any clarity over what could be deemed 'money' (Collins, 1988, p. 473). As such, if the monetary authorities tried to curtail supply of money in any one area, banks would simply substitute for a similar, money-like product in another. Moreover, the variety of credit instruments undermined not only the possibility of direct control of the money supply, but also the efficacy of interest rate management too. The rate on Treasury Bills could be directly set, and the price of new note issues also set by decree, but because of the rise of the parallel money market these were an ever diminishing proportion of the total monetary assets in the system (Revell, 1973). All of which made the authorities feel that calculating the money supply was impossible, and controlling it was even harder. The issue was one of capacity, rather than ideology. The idea of monetary targeting was not unheard-of and was not deemed unimportant, but it was rejected as a basis for policy because the authorities felt they lacked the means to make it workable. Instead the authorities used direct controls on clearing bank advances and limits on hire purchase lending, which were all part of Wilson's ambitions for a corporatist, productivist order that would enable the upgrading of Britain's manufacturing base (Kerr, 2001).

By 1967, however, with Wilson's corporatist ambitions failing to drive exports high enough to tackle Britain balance of payment problems, Wilson tried to jump-start export competitiveness by cheapening sterling. But devaluation came with a series of consequences that had a profound effect in shaping the institutional evolution of the postwar apparatus of economic governance (Cairncross, 1995). First of all, devaluation was accompanied by a significant rise in the Bank Rate from 6.5 to 8 per cent to appease the gilt investors who the Bank of England worried could 'lose faith' in the value of sterling, and there was an immediate freeze in



aggregate bank lending to all but the exporting industries and ship builders (Needham, 2014a, p. 23). Defence spending and spending on national industries was cut and corporation tax raised, all in an attempt to turn the current account around. Despite that, with foreign currency reserves already strained and confidence in sterling shook, Wilson needed to ask for a £1.4 billion IMF loan to support sterling (Needham, 2014).

IMF support came only with the condition that Britain would try to limit DCE. This was a fairly rudimentary metric of credit creation developed first by the IMF's director of research Jacques Polak in 1955 and was intended as a statistic to help discipline inflation in the developing countries in which the IMF normally intervened (Needham, 2014a, p. 7). In Britain's case DCE stood as a measure of the broad money supply, adjusted for balance of payments, and included in it a stable demand-for-money function based on a development of Milton Friedman's notion of permanent income, which had previously been seen by the monetary authorities as impossible to calculate and a further reason why monetary control was not viable (Laidler, 1989b). The IMF's point was that the balance of payments was worsened by an excess of credit which ended up being advanced to consumers who spent it on imports. As such the IMF's solution to the balance of payments problem was simple: reduce the expansion of credit. By 1969 the improvements in economic forecasting allowed the Treasury to include estimated projections of DCE. The IMF wanted a fixed target for DCE of £500 million a year but, as Wilson and his team pointed out, this was not possible in Britain's highly liquid financial system (Needham, 2014). In Britain, borrowers generally preferred overdrafts to more long-term and predictable bank credit (*ibid.*), and, secondly, could always access finance from the emerging parallel financial sector anyway (Einzig, 1971). Wilson's government fought off direct IMF conditions, but this desire to actively control credit expansion soon spread. There was still debate over whether a demand-for-money function could be calculated, but the fact it was codified institutionally by the IMF was significant.

Already here it becomes clear that the early monetary targeting did not come by sweeping away the governing apparatus that had developed. Contrary to what is implied by the notion of 'depoliticisation', the early targets were forged on an apparatus that aimed to control of balance of payments, not inflation, and focussed primarily at inhibiting consumer spending on imports (Oliver, 2014). In that sense they added to, rather than departed from, the pre-existing 'Keynesian' apparatus I

laid out in the third chapter. The intellectual attacks by monetarists - which were more sweeping - continued apace in the pages of the Financial Times with Samuel Brittan writing about the importance of the money supply, and the Banker magazine, which published many of Friedman's articles pushing the same cause (Middleton, 2013). Too often, however, our understanding of the importance of monetary targeting is drawn from a focus on the ideological writing of Brittan, Friedman and gang. While these were certainly significant in shaping the narrative of political debate, as I demonstrate their bearing on the actual institutional development associated with monetary targeting is less pronounced.

In December 1968 the Bank of England first published data and commentary on the broad money supply, £M3, based on what it called the 'counterparts' approach. £M3 was a measure of the "currency in public circulation and deposits (foreign and sterling) in UK banks" and derived from a simple equation: "PSBR, less gilt-sales to the non-bank private-sector, plus bank lending, plus foreign inflows" (Davies, 2012, p. 7). It was a measure that derived from the 'flow-of-funds' theory of the monetary order, which was ultimately founded on the idea that investment was solely driven by savings and in that sense there was no scope for government debt or private debt, over the long term, to sustainably affect aggregate demand. The £M3 figure was not yet used in policy but it already had two major implications. First, it offered a measure of the money supply, which had been deemed unfeasible in the Radcliffe framework (Needham, 2014a). Second, and crucially, it tied the calculation of the money supply to a function of the PSBR meaning that there were two clear routes to controlling the money supply: issuing more gilts and fewer Treasury Bills, and reducing public spending. This became vital in the way debt was governed in the years that followed.

Whatever their lofty aims, however, the monetary authorities did not yet have the capacity to govern broad liquidity through monetary targeting. This was because of the way that the gilt market operated. The contradiction between trying to squeeze credit creation on the one hand, and trying to support stability in the market for long-term government debt (the gilt market) on the other, meant that monetary control was impossible to implement. The Treasury was not opposed to the idea of limiting DCE, indeed they used ceilings on bank lending and hire purchase controls for this very purpose (Goodhart, 1989). But the Bank of England had, since the end of the first world war, acted as the principle dealer in its own securities, and felt it needed to 'manage' the gilt market in order to keep prices

steady. To do this the Bank would routinely buy up a load of gilts from domestic financial institutions and in doing so release the liquidity needed for banks to extend lending, at just the time when the Treasury (and IMF) were trying to limit credit expansion (Needham, 2014a). Both the Treasury and IMF were unhappy but the Bank was adamant that maintaining gilt liquidity was its primary responsibility.

At the same time the Bank was keen to respond to the problem presented by the credit revolution that had seen the discount markets be disintermediated by the rise of the parallel money markets. This undermined the importance of Treasury Bills and the significance of the Bank Rate in setting the price of liquidity in the financial system. Moreover, the more the Treasury used direct controls and ceilings on clearing banks, the stronger the hand of the parallel banks which did not face such restrictions (Goodhart, 2014a). These factors throw into a different light the significance of the emerging interest in monetary targets. Their importance was not initially about restricting the state's policymaking options, shielding democratic participation or absolving policymakers, rather they belonged in a context where the state was trying to enhance and deepen its capacity to direct liquidity flows and govern the economy.

The authorities' three problems - balance of payments, parallel banks and the national debt - left it in a bind. The other, longstanding impediment to implementing monetary control had been that the authorities did not yet believe it was possible to calculate the economy wide demand for money function. The uncertainty of this particular relationship - between changes in interest rates and changes in the demand for money - had been the subject of much debate since the end of the 1950s. Christopher Dow's work in 1959 and Milton Friedman's notion of permanent income grew in popularity through the 1960s, and both argued that a stable demand for money function could be identified. This vein of thought was then formalised further by the IMF through its DCE targets (Laidler, 1989b, p. 33). This is important, because if a stable relationship could be established between interest rates and people's demand for money, then it was possible to 'set' the amount of money created (to meet demand) by manipulating interest rates. The Bank felt it had enough of a handle on broad money supply to publish M1, M2 and M3 figures, but it was an improvement in data-gathering techniques that meant in March 26 1970 the newly formed Monetary Policy Group argued a workable demand-for-money function had been discovered (ibid.). As such it promised that credit and money could be controlled by interest rates, and in doing so reasoned that direct

controls on the traditional, primary banking sector could be removed. This of course would allow for the end to the disintermediation of the 'primary' banking system<sup>20</sup> offering the hope of dampening the effects of the credit revolution (Goodhart, 2014a).

The fix to both the balance of payments problem and the inability of clearing banks to compete with secondary banks lay with using interest rates to control credit. The only problem was the Bank's attitude to the gilt market. For decades the Bank had treated the gilt market as inherently volatile and in need of intervention (Hotson, 2010). With the national debt so large 'leaning into the wind' was needed to keep prices stable and appease creditors who bought gilts as a store of value (Goodhart, 2014), but, as I have mentioned, intervention would routinely flood the system with liquidity and push credit expansion up. It was a straightforward dilemma for the Bank. Dump intervention, but risk gilt market volatility and the chance of a national debt crisis; Or keep the gilt market in check but let parallel banks trample ever more over the regulated British financial system. Proper monetary targeting - using interest rates to manage credit demand - needed the Bank to let go of its belief that gilt market intervention was a necessity.

In the summer of 1970 their wish was granted. Michael Hamburger was on a secondment at the Bank from the New York Reserve and published a piece of research showing that gilt market volatility was better explained by external factors - Euromarkets, expected inflation, dollar-sterling relations - than the support, of lack thereof, from the Bank (Needham, 2014a, p. 34). As such in the June 1970 edition of the Quarterly Bulletin, the Bank of England's demand for money equation was published and with that the Bank was in place, as it put it, to unleash "the interest rate weapon that the Radcliffe Report specifically warned against" (ibid.).

To recount, in the time since Radcliffe was published in 1959, monetary thought and the apparatus of monetary policy had evolved. Through DCE and the broad, counterparts £M3 calculation, policymakers now felt they had a sense of money supply and its potential to influence balance of payments. In identifying a

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<sup>20</sup> Implied in this is an assumption that banks do indeed create credit in line with customer demand - something that occurred through the credit revolution - but that customer demand could be controlled through interest rates. As it turned out, customer demand for liquidity was highly inelastic to interest rates, and credit continued to climb (Goodhart, 2014a). But it was to take another twenty years for policymakers to accept this.

stable demand-for-money function, policymakers now felt they had an alternative means of controlling credit creation, through interest rates. The chasm that had grown between the cost of short-term borrowing on the traditional discount market, and costs on the emerging parallel money market, could also be solved in this way. The monetary authorities hoped that releasing direct controls on the traditional market would allow the two sectors to resemble each other, and thereby reassert the primacy of the discount market and the Bank Rate as the liquidity 'rate setter' across the financial system.

The goal of the emerging era of monetary control was to use interest rates to carefully vary the quantity of money that, it was thought, was the ultimate determinant of aggregate demand. This marked a shift from the immediate postwar arrangement where Labour chancellor Hugh Dalton tried to force interest rates down to the extent that they were an irrelevance to economic activity. Keynes, as part of his broader agenda of supporting producers over rentiers, wanted low interest rates across the board so that anyone needing to access credit to invest or consume, would be able to do so. This revival of interest rate management through the monetarist frame was to try to bring interest rates to the centre of policymaking, to make them the handle through which fine adjustments to final demand could be made. In that sense interest rate control was more not less politicised than before.

Having overcome the idea that the gilt market needed constant intervention, policymakers now felt able to use interest rates to contain credit expansion and solve the balance of payments problem that had hampered British policymakers for decades. This new dawn found form after Wilson lost the 1970 election. In the lead up to the election Conservative leader Edward Heath had, in traditional Tory fashion, promised a bonfire of the controls that limited the banking sector, and had proposed to replace the direct lending limits with competitive control via interest rates instead (Burnham, 2011). Shortly after he took office he launched the 1971 Competition and Credit Control policy. This was called the 'new approach' and translated all the developments in monetary thinking and institutional capacity discussed above, into a single policy and in doing so became the biggest shift in the management of government debt since Keynes's revolution forty years before.

### 5.3 The second target: Competition and (no) Credit Control

In examining how 'targets' became the central plank of monetary governance in Britain, and how this relates to the way government debt securities were used for

the purpose of economic governance, it is becoming clear that depoliticisation does not capture the significance of what was being constructed. The arrival of the first targets with the IMF in 1967 and their evolution into interest-rate based control of £M3 that was to take place through the CCC reforms, was about the state trying to establish a new settlement for the control of liquidity after the credit revolution. Interest rates, which had previously been adjusted to the rhythms of Britain's external deficits, became a central part of the domestic economy, transforming the way the gilt market especially functioned and the capacity of the monetary authorities to govern economic life in the process.

This, however, becomes more visible through an up-close examination of the evolution of the monetary infrastructure that public debt had established, rather than appeals to more windy notions about the ideology of monetarism. Certainly, the monetary authorities had little idea of the capacity they were creating for themselves at the time. Rather, the CCC reforms were a one-punch policy that aimed to solve a clutch of immediate problems confronting British policymakers. At once Heath hoped it could help free Britain's clearing banks, allowing them, driven by competition, to grow in size and capitalisation (Goodhart, 2014a). This, it was hoped, would check the progress being made by parallel banks, who were raising liabilities from wholesale money markets from which to rapidly expand their asset base; and thereby restore the primacy of the discount market and Bank Rate. What this meant was removing the limits that the state had put in place since the war on the expansion of clearing bank assets, ie letting the clearing banks lend as much as they wanted, and trying to control their lending solely through the Bank Rate instead (Davies, 2012). This was the great deregulation of banking that, as I discussed in the last chapter, is seen as a key moment in the credit revolution (for example Chick and Dow, 2013). But as I demonstrate here, it was a move designed for the opposite reason, to control the impacts already unleashed by the credit revolution.

Part of the reason the reforms get misconstrued as 'deregulatory' is the way the plan was articulated in the general terms of Heath's desire to "disengage the state" (MacDougall 1987, p. 184 in Burnham 2011, p.145). In typically monetarist terms the hope was that modern money could be made to behave like the ideal of commodity money. In that sense the desire was to establish a 'market regulation' of credit through CCC and that this market discipline would succeed where direct controls had failed in curtailing credit creation. Yet there was a tension between the

rhetoric of free markets and the fact that the monetary authorities were actually seeking tighter control. This latter part - a new mechanism for controlling credit creation - was voiced in terms of a monetary target, £M3.

### Implementing CCC

The CCC reforms were launched on September 1971. Over its two-year life it was, on its own terms, a staggering failure. By the time it was abandoned in 1973, £M3 had increased by 72 per cent, credit spiralled, asset-bubbles blew and the economy crashed (Needham, 2014b, p. 155). But the legacy was even more profound. First, monetary targets became a fixture of economic thought. Second, because CCC brought into being the belief that interest rates could halt money creation, and that monetary creation was a function of the PSBR, monetary targets came to be seen as a benchmark of future interest rates. Third, as a result of the previous two points, high interest rates, low public sector borrowing, and a bigger gilt market came to be seen as the ultimate weapon to tackle Britain's multifold economic problems.

Moreover, it demonstrated how misleading it is to take Heath's rhetoric of 'disengaging the state' at face value, and as proof of a trend towards deregulation or depoliticisation. Rather the integration of targets onto the British monetary infrastructure is better conceptualised as part of a qualitative change in the mode of state intervention. As part of the new settlement required after the credit revolution, the authorities needed an alternative to the combination of direct controls and the discount window, which were no longer impactful. CCC was an attempt to really try and make interest rates a powerful and flexible lever. This, however, was to come at the cost of stability in the gilt market, which was put under enormous pressure as a result of the attempt to make interest rates the main lever of control (Hall, 1992). The misfortunes of the CCC reforms reflected how intertwined banking and finance had become in the broader national economy. The monetary apparatus was so politicised it could never be the purely technical fix that CCC's proponents wanted.

To depart from the overly functional depoliticisation framework and examine more specifically what the reforms meant for the relationship between the state and public debt it is necessary to examine the context in which the CCC policy was implemented. Heath came to power in 1970 at a time of rising unemployment, union unrest and rising inflation (Kerr, 2001), as well as the growing governance problems being presented by the credit revolution. For Heath, a budgetary Keynesian in background, salvation lay in growth (Campbell, 1993). He thought

economy-wide growth would avoid a fight with the unions, and would also avoid a more radical remaking of the financial sector. As such after a brief experiment with tightening the budget he, together with chancellor Barber, set the dials of the macroeconomy to 'growth' with an infamously inflationary budget (Tomlinson, 1985). They went all out by announcing a GDP growth target of 4-4.5 per cent growth (Needham, 2014a, p. 50). Given that growth was less than half that when he came to power, it was an audacious claim. Heath imagined that growth would come from low interest rates, so his pursuit for growth collided fatally with the need for high interest rates to make the CCC policy work as the theory promised. As such when CCC was implemented in September 1971, the Bank Rate stood at 5 per cent (Bank of England, 2015, p. 1), a level that, as it turned out, was not enough to stem demand for credit.

Heath thought growth would come from increasing industrial productivity, something that those around him said could only be fostered by low interest rates. William Armstrong, a Treasury advisor to Heath, argued that Britain needed to build up industry on a Japanese and German scale (Needham, 2014a, p. 50). But this would need investment and public spending. Jim Slater, who at this time was at the height of his fame as a conglomerate magnate, was continually invited by Heath for advice on reviving British industry. Slater also argued that low interest rates would allow the private sector to invest and build up industry without the state getting involved and amassing more of its own debts (Kynaston, 2002, p. 473). Heath was left with a choice. He had been elected on a free-market ticket, and the ideals of the CCC policy fitted in with that. But to succeed CCC demanded interest rates so high that the parallel banks especially could face real difficulties. As such following the crisis of 1972 which started with the miners' strike in January, was followed by the state of emergency in February and then the imposition of the three-day week, Heath infamously changed course with the 1972 Barber budget.

It was a dash for growth with a bonanza of tax give-aways, but came for the first time in postwar history without direct limits on clearing bank lending. Perhaps even more crucially the budget allowed interest repayments to be deducted from income for tax purposes, despite Treasury advice that such a move risked a marked increase in lending and consumer spending. The changes were substantial: for a basic taxpayer the cost of debt servicing fell by 30 per cent, and for a highest rate taxpayer a staggering 90 per cent (Needham, 2014a, p. 52). The Economist urged readers to "go to your bank manager and demand a loan with which to flutter



in the City” (Reid, 2003, p. 59). And people did. Given that CCC was founded on limiting £M3 through interest rates, making borrowing instantly cheaper through the new tax regime meant the interest rate that would be required to even attempt to control £M3 was significantly higher. Moreover, instead of lending going to investment, asset prices spiked and money was funnelled into commercial property (Needham 2014: 52). There was no way interest rates could be raised high enough to curtail £M3 without damaging the economy further, and Heath was reluctant anyway because he bought the Slater logic that lower interest rates would induce industrial modernisation. The rush of demand for borrowing also fed the emerging logic of the credit revolution, which was to originate loans first, and buy ‘deposits’ afterwards. As one senior clearing banker told Margaret Reid (2003, p. 59) a decade later: “Almost for the first time in banking history you found your lending business then scurried round for deposits.”

Immediately, familiar problems resurfaced and these all coalesced around the operation of the market for public debt. The ‘Barber boom’, as it came to be known, created a forecasted PSBR of £3.35 billion, 5 per cent of GDP, for 1972/73. The Bank of England, fearing how the gilt market would react, felt it necessary to try and force up long-term rates by increasing the Bank Rate by a further 1.5 per cent, taking it to over 10 per cent (Needham, 2014a, p. 52). Nonetheless, the hope of relying on gilt sales to fund the PSBR was not met in its entirety, especially because in the new regime the Bank offered less support to the gilt market. The main alternative to gilts was to finance the PSBR through Treasury Bill sales to banks. The Bank of England calculated that £700m of Treasury Bills would need to be sold, which was easy enough in itself, but given that Treasury Bills were a highly liquid asset that could be used to meet banks liquidity positions (in the manner I described in the previous chapter), issuing Treasury Bills fuelled the dynamics of credit creation, and pushed up £M3 even more (Needham, 2014a).

By July 1972, less than a year since it begun, CCC was suffering. Not only was Heath refusing to increase the Bank Rate to a level that the Bank of England felt was appropriate for the £M3 target, but economists at the Bank of England were reporting ‘considerable problems with its equations used to predict the demand for money’ (Needham, 2014a, p. 58). Whether this was because of an unexpected inelasticity of demand to interest rates, or more likely that the Bank Rate was still not the setting short-term rates across the parallel markets, the entire edifice of interest-rate controlled monetary targeting was collapsing (Davies, 2012). The

effects of this were felt on the operation of the clearing banks too. To recall, before CCC lifted caps on their asset growth, they operated as a cartel with a fixed spread between their lending and deposit rates. With the CCC changes, a 'merry go round' developed because banks used to bid for deposits by offering attractive rates on deposits and generous rates on overdrafts (Goodhart, 2014a, p. 12). Because traditional retail bank sector lending was mostly on an overdraft system, private companies had the choice of making payments by drawing down on their deposits or by using overdraft facilities - and this choice obviously depended on the spread between the interest they received on deposits and the interest they paid for overdrafts. When the spread was narrow or even negative - as was the case between 1971 and 1973 after the CCC reforms - companies borrowed solely to swell their interest-bearing deposit account. This borrow-to-deposit strategy came to be known as 'round tripping' and drove a huge increase in bank lending (ibid.). It exposed the fundamental flaws in the reasoning driving CCC. To recall the authorities were trying to bring credit creation under control on the belief that it drove balance of payment and inflation problems. Credit creation could be limited by direct controls on advances and overdrafts, which would choke off supply, or by higher interest rates, which would choke off demand. Yet this would not work because of the banks' ability to raise deposits from parallel wholesale money markets.

The problem was still the need to bring the Bank Rate on the discount market into line with broader short-term liquidity rates (Revell, 1973). That, ultimately, was to require reform of the way the Bank Rate operated, something tackled in a sweep of changes to the financial sector made by Margaret Thatcher's government, which I examine in the next chapter. In what follows initially, however, I assess how the CCC reforms affected the workings of the gilt market

### ***The 'New Approach' in the gilt market***

By sacrificing interest rate stability, gilt yields became more volatile and demand for government debt less reliable (Thomas, 1986). To recall, in order to make flexible interest rates the workman of systemic liquidity control, the monetary authorities had to stop the policy of 'leaning into the wind' by intervening directly in the market for gilts to keep prices stable, because swapping cash for gilts released liquidity into the banking system. The way this support was removed also meant providing less support to the jobbers who had dealt in the gilt market. Previously in the Bank's

capacity as a dealer of last resort, it would facilitate switching through buying gilts back on the secondary market at market rates. After the CCC reforms the Bank no longer guaranteed to buy stock outright (except those gilts with a maturity of under a year) and instead would only buy stock at prices of its choosing (ibid.). The authorities' commitment to maintaining stable market prices had, in that way, given in to their commitment to (try to) control liquidity. The effect was to emphasise short-term fluctuations in gilt prices, something that the existing operation was not really well placed to manage. As Tony Coleby, head of the Gilt-Edged division at the Bank of England, later summarised:

“When, in 1971, the Bank resolved to change its earlier practice of routinely supporting the market by buying stock in at close to prevailing market prices, it recognised that that could create a problem for the ability of the gilt-edged jobbers to maintain their market-making function” (in LSR, 2006, p. 5).

Though the Bank had been convinced that factors outside its control drove gilt volatility, the effects of CCC made it reluctant to abandon the gilt market entirely. And in that sense it is again misleading to judge the significance of monetary targeting in terms of the rhetoric that surrounds it, because despite ideological insistence about the importance and efficacy of ‘market governance’ and market management, policymakers always felt compelled to intervene and manage the supposedly liberalised regime. The primary responsibility of the Bank, after all, was to ensure stability of government financing. As such the monetary authorities tried to find other ways to support the market. This was becoming increasingly important because it was around this time – the mid 1970s – that growing inflation made gilts less attractive (Thomas 1986, p. 64), and low growth made the government's borrowing requirements really expand. The Bank experimented with new gilt products in the hope they'd be more attractive to investors. These included issuing gilts on a partly paid basis; issuing convertible stock (in 1973); and issuing variable-rate stock (in 1977) (Thomas, 1986). To overcome the uncertainty created around expected future rates of inflation, the Bank introduced index-linked stocks in 1981, insuring investors against inflationary shocks. Though the Bank created all kinds of new products and intervention strategies to stabilise the gilt market, they were piecemeal and insufficient in an environment where interest rates were being varied to try to control credit creation. Nigel Althaus, the head of the government broker, Mullens, later summarised the nature of the predicament perfectly: “The monetary

control period put huge pressure on gilt-edged sales, such that they became the most important workman of economic control, which the old market was not designed to be or to do” (in LSR, 2006, p.3).

Clearly the pressure on the gilt market was growing. This pressure came not from the national debt suddenly becoming unsustainable, but rather from the way the monetary infrastructure had evolved to make the gilt markets central in the control of liquidity. Mobilising monetary targets was never going to dissolve this infrastructure or the onus on the authorities to use public debt for the purpose of governance. In that sense it is unhelpful to conceptualise targets in terms of depoliticisation.

#### 5.4 The third target: “Sadomonetarism” and the public debt

By the mid 1970s Britain had twice experimented with monetary targets. First with the IMF’s attempted imposition of limits on DCE, and then again with Heath’s plan to control £M3 through the CCC policy. The result of which had been to heap pressure on the workings of the gilt market that was not yet able to cope with the new era of interest-rate volatility. More pressingly still, the British economy was still suffering, inflation was high and the country’s external deficits a significant issue. The OPEC shocks and global recession that had formed part of the economic chaos of the early 1970s, and led to sterling following the dollar away from a fixed exchange rate, meant that the newly elected Labour government in 1974 faced significant economic problems. Its broad strategy “was to attempt to ‘tunnel through’ to economic recovery using borrowing (not just from the IMF, but from OPEC governments, and where possible Eurocurrency markets)” (Clift and Tomlinson, 2008, p. 560). As such it laid the foundations for what became the infamous 1976 IMF loan with its accompanying ‘monetarist’ targets on £M3 growth. Though Britain had repeatedly drawn on the IMF for the previous two decades this £3.5 billion loan package became highly symbolic (Kerr 2011, p. 161). Under Labour’s watch Britain had turned ‘cap in hand’ to the international community, and when the loan was followed soon after by the manufactured ‘winter of discontent’ (Hay, 1996), Labour’s economic reputation was buried for a generation. Moreover, the targets that the IMF imposed, or at least attempted to impose, amounted to the third attempt at governance through targets. These targets were notionally established first under Denis Healey’s watch as Labour chancellor, a ‘disbelieving monetarist’ as he described himself (Healey, 1989). Though articulated around monetary growth

(£M3) most attention fell on the PSBR (Kenway, 1994). The deflation that accompanied them, along with Jim Callaghan's famous declaration to the Labour party conference that it is "no longer possible for a government to spend its way out of a recession", has come to be seen as the final nail in the coffin of Keynesian governance and confirmation of the neoliberal ascendancy (Skidelsky, 2009). Yet behind the rhetoric, the story remains more nuanced. As Burk & Cairncross (1992, p. 228) summarised: "Apart from the continued issue of monetary targets, which were rarely hit, economic policy in the last years of the Labour government differed little from what it had been before the arrival of the IMF." Nonetheless, monetary targets and their links to government borrowing, formed a crucial plank of Thatcher's rise to power and the targets took their most memorable form in her early, brutal economic experiment, the MTFS.

The MTFS is something that continues to resonate in popular memories of 'Thatcherism', but was simply a framework for economic strategy that outlined fixed financial objectives for monetary and fiscal policy. It was supposed to signal a final move away from the 'discretion' of policymakers to fixed, publicly announced principles. As Nigel Lawson wrote in an article for *The Times* in 1978, the MTFS was about showing that "Rules rule: OK" (in Ridley, 2014, p. 68). These rules were long term, laying out policy commitments for the following five years (Keegan, 1984). All of this was built on the monetarist thinking and monetarist assumptions and was constructed on the existing architecture of monetarist policymaking in Britain developed through the DCE and CCC calculations. And the implications of the MTFS was clear: government had set out a framework for containing monetary growth, there would be no dabbling in expansionary programmes, this was pure deflation with no political 'interference' (Kerr, 2001). On the face of it, this was the deflationary depoliticisation for the credit markets that Burnham and others describe.

Yet, the status of the targets themselves, and the way investors reacted to them, was much more ambiguous than the depoliticisation literature would imply. Put simply, the rules and targets were entirely ignored (Cobham, 2003). At first there was internal debate among Thatcher's advisors, and between the Treasury and the Bank of England, over which monetary aggregate was to be chosen (Kenway, 1994). Then, when they eventually committed to £M3 (for the reason that it was the sole variable government had notional influence over because of its relation to the PSBR), the targets were, again, entirely incoherent. The figures

appeared to be chosen entirely arbitrarily. They did not even correspond to the official forecasts for money GDP, or the previous level of money GDP, or the previous growth of £M3 (Cobham, 2002). Moreover, they were entirely unexplained, with the government not once accounting for why or how the numbers were set the way they were (*ibid.*). Even on their own rather narrow terms, the monetary targets did not correspond to any kind of strict economic theory or economic logic (*ibid.*).

There was quite a contrast between the fanfare of the targets published in the MTFS, their ultimate importance, and the rest of the Thatcher administration's economic policies. Certainly between 1979-1982 some of the choices on fiscal policy did not align with the MTFS aims on PSBR and inflation targets (Prasad, 2006). The cut in top-rate income tax, for example, was (part) financed by doubling VAT to 15 per cent, which immediately meant inflation increased greatly (*ibid.*). Moreover, a promise (which Thatcher alone deemed essential for securing the election) not to cut public sector pay left her administration scrambling for places to cut the government spend. Revenue was pulled in from higher NHS prescription charges and an increase in council rents, but these weren't sufficient to deal with the income tax cut and the rise in social security spend that accompanied higher unemployment with the autumn 1981 recession (*ibid.*). This policy incoherence made achieving the MTFS targets hard to meet. The other major problem was that the credit revolution had of course made monetary targeting particularly difficult. Banks could not only raise money from wholesale markets to lend, but were now beginning to securitise their own assets and sell them to fund further lending (Smith 1987). The effect of financial innovation – especially the development of liability management - was to increase demand for debt and liquidity. Moreover, the rise in the proportion of financial intermediaries' deposits that were interest-bearing would have reduced the interest-elasticity of the demand for money, broad money in particular (Cobham, 2003, p. 39).

Unsurprisingly, all the targets were routinely missed. The targets on £M3, on PSBR, the expectation of GDP growth, all were overshoot. In that sense, the MTFS was a failure. Certainly, with the economy in the doldrums by 1982 there were widespread accusations that Thatcher's high-interest rate 'sadamonetarism' had sunk the economy (Keegan, 1984). Many at the Bank of England, who were sceptical of monetarist assumptions after the CCC fiasco, and worried about the effect the high interest rates were having on British industry (especially because it kept sterling very high), were fed up (*ibid.*). Moreover, there was a broader distrust

of the scientism of monetarism that sat uncomfortably with the British tradition for pragmatic administration. As Goodhart (2014b, p. 94) wrote dismissively:

“[Monetarist] econometricism encourages lay people to believe that scientific discovery in economics, by white-collar people working with statistics, equations, and computers, can in practice provide the solution, or solutions, to obstinate economic problems. It is only when one observes the often remarkable correlation between the output of models and the political attitude of their operators that one begins to see through the mists of algebra the familiar landscape of economists disagreeing with one another and of laymen using abstract economics to support their own prejudices.”

Three years after the MFTS had been announced, and interest rates had touched 15 per cent, unemployment had increased and growth was still low (Keegan, 1984). Industry had been successfully destroyed and the collapse in employment fixed the ‘wage-push’ aspect of inflation. It is now a common refrain among critical writers (for example Seymour, 2003), and indeed some of Thatcher’s closest advisors<sup>21</sup>, that the whole MTFS affair was a “front” for killing off industry and the unions that were based around them. This may well be a fair assessment but it does not change the impact the MTFS had on the gilt market and the changes that followed as result. This came again from the way that £M3 was calculated. To recall, gilt sales to the private sector helped to bring down £M3, and as a result, the targets laid out in the MTFS meant trying to broaden the market for government debt.

The Wilson report, published two years after Thatcher and Lawson had established the MTFS as their defining economic framework, laid out the dilemmas facing the monetary authorities: “The size of the PSBR,” it wrote (1980, p. 178) “and the techniques of debt management are inseparable from monetary control”. In an environment where, thanks in large part to the government’s insistence on its importance, monetary growth was deemed a crucial indicator of potential inflation and thereby of the risk of holding government debt securities. For that reason, gilt sales were increasingly being watched by the merchant banks and fund managers representing institutional investors as a sign of the government’s commitment and ability to meet its monetary targets. This meant, as the Wilson report noted, fluctuations in government borrowing and debt sales often gave rise to expectations

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<sup>21</sup> In a BBC documentary Alan Budd, special advisor to the Treasury in Margaret Thatcher’s government, told Adam Curtis (1992) that he suspected high interest rates might have been about trying to create high unemployment to break the power of the labour unions.

of action by the authorities (through the Bank Rate) which caused further volatility to the government's financing. As it concluded (1980, p.181): "The traditional method of selling gilts was not designed for present circumstances."

The appeal of monetary targeting first found prominence as a response to the problems presented by the rise of parallel banking and the disintermediation of the traditional discount market. This, as part of a wider revolution in credit, meant that there was an overabundance of liquidity that the authorities felt adversely affected Britain's balance of payments. Their solution was to try and control liquidity by varying interest rates in line with fixed targets on monetary growth. This has since been cast as a depoliticisation of monetary governance, an attempt by state officials to seal themselves off from democratic scrutiny and establish a system of governance that proved to financial markets the 'credibility' of the government of the day. What is missed by the depoliticisation account, however, is the specific way in which the mode of governance changed and the affect this had on markets for government debt. In particular, the operation of the gilt market was dramatically changed through the monetary control period.

The gilt market was made a crucial engine of economic governance at the same time as an important mode of Bank of England support in the market was withdrawn. Not only was the gilt market more volatile in this regard, but as Aled Davies (2012) describes, the targets also reshaped the way investors acted on the gilt market. First, it worked to harness cohesiveness of gilt investors, making them move together in buy and sell positions. Second, it worked to make interest rate expectations a more central part of the way the financial sector operated.

Before the reforms, the Bank was able to manage gilts according to the 'cashiers' approach - acting as a dealer in its own securities to keep interest rates steady and liquidity high in the way I mentioned previously. Under this arrangement, steady interest rates meant few risks to holding gilts. The new era of using variable interest rates to target monetary growth shifted the imperatives of the gilt market. No longer were gilts simply a safe haven, controlled for volatility. Instead the Bank managed the gilt market through what Peter Hall (1992) describes as an 'economists' approach, where gilts were marketed not on their stability but on their potential to offer large capital gains. As such one of the key things constructed through the attempts at monetary targeting was to transform gilts from an object of security to an object of speculation. This latter, 'economists' approach to managing the gilt market worked like this: the authorities would force up interest rates to a



point where it seemed they could go no higher, and then, believing interest rates would then fall, investors would buy gilts because as rates fell, bond prices would rise and they would be holding a rapidly appreciating commodity (ibid.). The reverse held true too. It was, then, a means for the monetary authorities to try and stabilise financing its debts and ward off any potential national debt crisis. The more the monetary authorities acted in this way, however, the more it increased cohesiveness of the market because gilt buyers were together trying to eye the 'peak' in rates. In order to function this cohesiveness was necessary.

The consequence of this was to force gilt investors to pay much more attention to predicting changes in interest rates, which in turn, was something that could, in theory at least, be worked out from the monetary targets. In the early years of the CCC, many brokerage houses went bankrupt, unable to cope in the new era where gilts were no longer guaranteed stability. As time went on, however, the new mechanism became more deeply institutionalised with brokers hiring specialist economists to monitor government policy more precisely and try to calculate possible movements in interest rate (bid). They paid much more attention and offered verdicts in circulars like Philips and Drew's *Economic Forecasts*, Greenwell's *Monetary Bulletin*, Capel's *Discussion Papers*, Messel's *Monthly Monitor*, Rowe and Pitman's *Market Report*, and Vickers da Costa's *The British Economy*, all of which offered (usually gloomy) verdicts on government policy cast in terms of the likelihood that government policy would meet the targets established (ibid). As was written in a 1979 Rowe and Pitman circular:

"If . . . the financial markets consider that the consequences of the fiscal policies announced in the Budget will be a Borrowing Requirement in excess of £8.5 billion, confidence will be impaired and interest rates will have to move upwards again in order to keep monetary growth under control." (Market report March 1979: 3 in Hall 1992, p. 112).

It was clear then that the national debt had played as significant a role in shaping Britain's monetarist experience as it had its Keynesian period. Indeed, it was the continuity that helped lead the evolution from the Keynesian era after the war to the monetarist era of the 1970s and early 1980s. Throughout the broad issues with Britain's economy: low growth, balance of payments problems and high debt had remained stubbornly in place. From the perspective of the monetary authorities the monetary politics of the time centred around interest rate management. In this regard the effort to establish targets had politicised monetary governance more

than ever. Precisely because the existing governance infrastructure was not swept away and replaced by 'market governance', introducing targets meant updating and reshaping the mechanisms through which governance already took place. As a result, in order for the state to both finance its spending securely and try to manage liquidity more effectively, there still needed to be better mechanisms to influence interest rates. The monetary authorities still confronted two problems. First was the need to check the ceaseless liquidity that the revolution in the money markets made 'the new normal', and specifically how to make the Bank Rate effective. And secondly how to separate monetary policy from debt management by changing the way the gilt market operated.

## Conclusion

Monetarism was a long time coming in Britain. Far from beginning with Thatcher, the first targets came from the IMF in the late 1960s. Though the gradual imposition of targets did work to transform monetary governance in Britain, they did not result in a depoliticisation. Indeed, to invoke the term is to simply overlook the politics of monetary targets. By negating the way in which public debt came to function as money in Britain, and thereby dissolve the limits on the levels of debt that the country could raise, the depoliticisation literature relies on the idea that indebted states design their techniques of monetary governance to simply achieve credibility in the eyes of financial markets. As such developments in monetary governance are seen as originating in the demands of creditors.

Yet through revisiting the emergence of monetarist thinking and the various attempts at monetary control I showed that monetary targeting came from an attempt by policymakers to regain control of credit creation after the credit revolution. I then showed how the attempt to use interest rates to manage the growth of the money supply failed monumentally, but created a new position for the gilt market where the price of long-term government debt was less supported by the monetary authorities. This placed enormous pressure on the gilt market and meant that by the early 1980s reform was needed for gilt financing to remain secure. At the same time the hope of overcoming the disintermediation of the discount market, and re-establishing the primacy of the Bank Rate in setting the price of liquidity had also not been achieved. That would require reform of the market for Treasury Bills.

By tracking how the attempt to impose monetary targets affected the broader workings of the financial sector in Britain it is clear how politicised the

process was. That the targets were so often missed demonstrated how they were no limit on the state's scope of economic action. As such, rather than the unspecified terrain of depoliticisation, I have used this chapter to establish an institutional grounding from which to examine the financial reforms of the 1980s. In the next chapter I explore two key changes, the move away from the 'discount rate' in 1980 and the 'Big Bang' deregulation in 1986. I show how these changes are best understood as an attempt by the state to enhance its capacity for governing liquidity across the economy through its use of public debt securities.

## 6. Deregulation in the debt state

### Introduction

There is an enduring myth that the Thatcher regime, which ruled Britain through the 1980s, was committed to 'monetary discipline' (for example Kerr, 2001; Green, 2013; Burnham, 1997). Whatever Thatcher may have preached about the importance of thrift and the virtues of the household budget, the fact remains that over the course of her time in power the state ran repeated deficits, the public debt increased, and private debt exploded (Rogers, 2013). The fact that critical commentators still use the notion of monetary discipline with regards to Thatcher is testament to the strength of the monetarist framework that pitted monetary stability against economic democracy. Because when authors like Kerr (2001) discuss the political significance of Thatcher they do so in terms of the sacrifices the country was forced to make to bring down inflation. This reading implicates a broader understanding of the transition to neoliberalism in Britain. Thatcher is presented as a final 'break', bringing to a close the supposed consensus on Keynesian governance that had ruled since the second world war, one where the state had for too long used growing public debt to compensate for the country's continued economic decline. In opposing Thatcher's new monetary discipline with the period that preceded her, it becomes very difficult to account for how and why the national debt only expanded under Thatcher. Even when commentators acknowledged what happened to public spending during her time in office, they do not use this to question the substance of the transformation she represents. Instead, authors like Chris Rogers (2014) take it as proof that the language of 'discipline' was cover for a more targeted, 'ideological attack' on a particular tranche of society (organised labour in particular).

Yet the politics of the Thatcherite monetary reform look different when considered in light of the history of public debt in Britain. As I have established, the ability to raise and service ever growing public debt was forged on the way public debt was steadily monetised since the seventeenth century Financial Revolution in Britain. The gradual institutionalisation of public debt into the workings of the broad economic system in Britain meant that throughout its history monetary stability was less a trade off with economic democracy than it was about governing liquidity.

When posed this way, Thatcher's reforms were less about dismantling the governing infrastructure that had gone before, and making a sharp break from the past, and more about tackling distinct problems that had arisen in the governance of liquidity, so as to smoothen the operation of monetary policy and debt management in Britain.

As such in this final chapter I focus on two key reforms to the way debt was managed - reforms that are often understood in terms of monetary discipline and creditor power – and demonstrate instead how they helped the state better manage its large and growing public debts. The context was key, because by the early 1980s it had become clear that, in regard to the management of public debt, two problems needed to be solved. First was finding a way for the Bank Rate to affect short-term liquidity in an environment where Treasury Bills were no longer the dominant short-term security. Second was finding a way to greatly expand the gilt market which was now relied upon to provide a bigger proportion of government debt financing. When the period is examined in these terms, the regulatory changes made to the financial sector are put in a different light. What looked like monetary discipline appears more fruitfully as developments in techniques of debt governance. Perhaps more importantly, when considered this way, there is a basis for rethinking the broader neoliberal period and the ever more sophisticated way the state has used monetary management to govern the economy. As such in this chapter I examine two key episodes of financial reform. The first is the Monetary Control Act of 1980 and the second the 1986 Financial Services Act, better known as the 'Big Bang'. They involved reforming the operation of the market for Treasury Bills and gilts, respectively, and helped broaden the market for public debt and fine-tune the ability of the state to govern through debt. What was produced as a result of the reforms was not a state with direct controls on banks and money, and how much was lent to who and on what terms, but a looser leverage over the system as a whole.

The chapter is divided into three sections. I begin by examining how the idea of 'monetary discipline' has become a defining feature for the understanding of monetary governance under Thatcher. I show how it is often depicted as a creditors' triumph, making it very difficult to conceptualise the power of the state in contemporary debt politics. The second outlines how the Bank of England reformed the way it sets the Bank Rate. Whereas previously rates were set through the discount window, after the Monetary Control Act of 1980 rates were set by the

Bank's direct interventions into the bill market. This provided greater flexibility for the Bank Rate and helped it adjust more swiftly in line with developments on the broader money markets, something that had become crucial since the traditional discount market had been disintermediated by the credit revolution. The third section examines how the reforms made to the London Stock Exchange through the Big Bang in 1986 tackled problems that had developed in the gilt market since the start of the monetary targeting two decades previously. The reforms ended up greatly expanding the size and liquidity of the gilt market, and separated the issue of debt management from that of setting monetary policy for domestic control.

### 6.1 The debt state: Monetary discipline?

A key idea that undergirds examination of the politics of public debt is the notion of 'monetary discipline'. What this involves precisely is rarely clear but in Britain there is a sense that discipline was achieved in the 1980s (for example Green 2016; Kerr 2001; Ingham 1983). It is a process that had supposedly begun with a move away from Keynesian governance in the early 1970s, continued through the imposition of market-managed credit and the depoliticisation of economic policymaking, before finally reaching fruition with Thatcherism in the 1980s. Having struggled for it since public debt exploded in the second world war, Thatcher managed to restore monetary discipline to Britain (Green, 2016). Associated with it was a sense of a competitive, market-based order to social relations, a dominant financial sector, an austere public exchequer, and rampant deregulation (Blyth, 2013). In that sense monetary discipline seems an aspect of neoliberalism.

Yet what exactly does it mean to impose monetary discipline? How can it be assessed? And, most important for my purposes, what did monetary discipline imply for the way public debt was used in economic governance? The British case is particularly intriguing in this regard because it is widely acknowledged that inflation came down under Thatcher, and that, during the brief years of the MTFS, interest-rates reached eye-watering highs (Gamble, 1994). Moreover, swingeing cuts were made to parts of the public sector (Prasad, 2006). On the face of it, this seems like the moment where Britain, having mounted debts for decades, finally had to pay up. Yet at the same time it is well known that private debt expanded rapidly (Montgomerie, 2015), Thatcher ran repeated budget deficits - pushing up the national debt - and financial speculation was opened to masses of the

population (Moore, 2014). All of which muddies the clarity of the concept of monetary discipline.

To square this apparent contradiction, the literature (for example Green 2016; Kerr 2001) relies on the notion that the principle of monetary discipline is one that favours creditors and the financial industry more broadly. As such when state authorities established and imposed monetary discipline, they also sealed the dominance of the creditor class. As I have argued throughout the thesis, this stems from a very one-sided reading of debt politics that fails to examine how the moneyness of public debt constructs a monetary infrastructure that embeds public debt very deeply into the workings of the broader economy. In that sense while it is obvious that a creditor would prefer 'monetary discipline' to guard against their investments being 'inflated away', it is much less clear how this discipline would be achieved and who would be targeted to secure it. Moreover, equating monetary discipline to creditor dominance forces a very narrow reading of the state's involvement. Restoring discipline requires a strong state to construct it, and in that sense the state is more than the 'nightwatchman' upholder of the laissez-faire fantasy of liberal economics. Yet the notion of 'monetary discipline' necessitates a very stunted kind of state agency. It is rendered in instrumental terms where the state acts to service the creditor class. This stems from a deeper shortcoming in the conceptualisation of debt politics that I have discussed throughout the thesis. Simply, by occluding its monetary aspects, a growing debt becomes necessarily unsustainable and monetary discipline, demanded by creditors, the only solution. The result is a reification of creditor power that makes it very difficult to understand how state action in finance can develop from other pressures and serve other ends than those demanded by creditors. Moreover, it occludes how the pursuit of monetary discipline will always be refracted through a deeply entrenched monetary infrastructure.

These shortcomings are especially apparent in the literature on financial regulatory reform. It is often assumed that the many regulatory changes that took place under Thatcher were compelled by the financial sector and served financial interests (for example Gamble, 2009; Kirkland, 2015; Hudson, 2013; Peck and Tickell, 2007). Moreover, there is a sense that this was both an expression, and a further cause, of the state's subordination to creditor interests. Streeck (2014b), for example, argues that monetary discipline and financial deregulation are all part of the same process. While literature specialising on the British case sees in

Thatcherism the final victory for the City-Bank-Treasury nexus (aided by US financiers) that had long dominated British capitalism but was briefly threatened by productivist forces after the war second world war (Kerr, 2001; Green, 2013). This sense of a financial sector dictating regulatory reform makes it especially difficult to understand the reforms to the market for debt management that took place in the 1980s. The Monetary Control Act of 1980, and Big Bang reforms in 1986, transformed the way public debt was sold. They had important implications for the way monetary discipline was pursued and, in the case of the Big Bang especially, show how the state can act to increase the size and liquidity of the market for its debts.

Both episodes are much studied, often celebrated, and sometimes lamented, yet rarely is there any mention of the lasting significance the reforms had on the operation of public debt management. Instead critical literature focusses on how they helped to establish monetary discipline, impose 'market rule', and empower Britain's financial sector. The only thing that separates critical literature from the mainstream in this regard is the fact that the former spells out how necessary the state was in the construction of this order. It is why critical literature on the Big Bang, for example, emphasises how regulation became "far more complex" (Cerny, 1991, p. 177) as a result of the reforms and that "freer markets" needed "more rules" (Vogel, 1996). What the critical literature does not disturb is the mainstream idea about what was constructed through the reforms. Whatever the details of the state's involvement, the outcome remains the same: monetary discipline, creditor rule.

One thing particularly notable in this regard is the way Thatcher's pursuit of monetary discipline and financial regulatory reform is cast - whether for good or bad - as a project to re-establish the dominant position of the creditor class and financial sector, and London's role in international finance. In the context of financial globalisation, Thatcher responded to the supposed threat of Britain becoming a financial backwater. This notion deeply implicates how changes to regulation are read. Philip Augar (2000), for example, argues that the Big Bang was driven by the worry that British financial houses would be incapable of competing with international investment banks in the market for corporate equities. Given that in a globalised financial market investors could take their business to wherever commission fees were lowest, reform was deemed necessary. Nestled in this explanation is the idea that creditors can use markets to exercise their will. By the



1980s the character of financial markets had changed to flip the balance of power to investors (Laurence, 1996). Where once the sellers of securities could dictate terms, the rise of institutional investors now gave market power to the buyers. Their capacity to 'exit' the market - ie stop buying securities through the exchange - overwhelmed the previous small establishment who had relied on their 'voice' being heard by their close association with regulators (Poser, 1988). As such Thatcher's desire to uphold the wishes of the financial sector, and secure its future, meant forcing through regulatory reform.

Yet in reality the City was never in danger of slipping into irrelevance. It was booming in the second half of the 1970s leading up to Thatcher's appointment (Plender, 1986) and the presence of the Euromarkets in London meant the City hosted international financial houses in an incredibly modern market. Though the Euromarkets were not within the Exchange itself, they were in the City and by 1983 had deposits in the region of \$1,050 billion (Burn, 2006, p. 17). By the 1980s, they were also developing into a potent source of corporate finance (Eurobond issues reached \$150 billion in 1985 (Plender, 1986, p. 43)) and were populated by banks from across the developed world (Cassis and Battilossi, 2002, p. 108). Even popular commentators at the time recognised that the development of the Euromarkets was a 'Bigger Bang', than any of the changes made in the 1980s. While the Exchange may have shrunk, there was never a question of the City more broadly becoming a financial backwater (Plender, 1986). As one prominent commentator Tim Congdon (1986) put it: "Today [the City] is the hub of a new and vast capital market without rival anywhere. It is surely preposterous to describe the City as 'uncompetitive'."

For that reason, it is misleading to think that financial reform was driven by the desire of creditors to restore the dominance of Britain's financial sector. Moreover, as always, regulatory reform also targeted particular parts of the financial sector, hindering their development and privileging others. The effort to impose monetary discipline and the change to the way the Bank Rate was set, was I argue, spurred by the desire to find a way to rein in the parallel banking sector. Similarly, the Big Bang reform to the Stock Exchange - and the gilts that were sold on it - actually spelled the end for many traditional financial houses in Britain who, as I will discuss, were overwhelmed by American competitors.

In that way there is a problem with the notion of monetary discipline, because its framing of state action as functioning creditors and financial markets is

misleading. After all, what is ultimately at stake in this thesis is conceptualising how public debt can be a basis for state power. I would argue that the two reforms demand a reassessment of the politics of the debt state and the association of Thatcherism with monetary discipline. It is my contention that the effect of the Monetary Control Act was to enhance the state's capacity to react to developments on the parallel money markets, while the Big Bang is similarly better conceptualised as an example of the state acting to widen the market for its own debts. In making this argument I call into question the efficacy of 'monetary discipline' as a framework for conceptualising the politics of public debt.

## 6.2 Monetary Control: Open market operations

By the start of the 1980s, one of the biggest debt problems that had developed over the previous twenty years was not the size of the public debt, *per se*, but the declining role liquid public debt - central bank cash and Treasury Bills specifically – played in the provision of liquidity to the broader economy. Since the credit revolution and the arrival of new private liquid securities like CDs and Repurchase Agreements, banks relied much less on public debt to meet their liquidity positions. This was a problem. Not because it threatened a government financing crisis, but because it meant the mechanism for setting the Bank Rate - via the discount window on the traditional discount market - was by the mid 1970s no longer the most relevant rate for short-term liquidity. As the Treasury itself laid out, "liability management... can produce large swings in the short-term interest rates [and] reduces the ability of the authorities to "fine tune" the money supply" (HMT, 1980, p. 6), the result of which being the Bank Rate had very little bearing on bank lending (*ibid.*). The Bank of England's monopoly provision of public debt securities through the discount window had been one of the most important ways in which public debt had been a basis for state power to govern the economy. It was a clear example of the way that public debt was used for far more than simply meeting the state's fiscal spending requirements.

In 1980 there was a major shift in how the Bank Rate was handled. Public debt securities were still the basis of setting rates but there was a recognition that central bank liquidity did not matter so much anymore. Instead the Bank Rate would be set by the Bank of England dealing directly on the bill markets, and no longer through the discount window. The rhetoric was about letting 'markets' set the price, with the Bank adjusting quantities in accordance; but the goal was explicit: better

monetary control (Cuthbertson, 1984). This was a process that had been a decade in the making, beginning with the botched CCC policy and then taking an important turn with the panicked establishment of the MLR policy soon after.

It can be difficult to capture the broader significance of such technical adjustments, particularly when they came shrouded in a language of grand ideological claims. Heath had talked of the ‘disengaging of the state’, while Thatcher presented all her reforms in the grandiose terms of a historical struggle for free markets. Understandably literature examining financial reform in the 1980s is fixated with this elevated level of grand abstraction. For that reason, technical adjustments seem only part of a broader mission to ‘free markets’ and assert the dominance of creditors. My contention is that when examined as part of the infrastructure of governance, however, these financial reforms are better understood in terms of the power they granted state authorities. The eventual shift made with the Monetary Control Act of 1980 did not grant the state power of decree in the provision of banking sector liquidity, but as I show in what follows, it did help establish some leverage over a financial system that had changed markedly as a consequence of the credit revolution.

Most of the discussion about the Monetary Control Act has focussed on the debate it sparked about the choice of monetary aggregate that the authorities hoped to control (for example Needham, 2014; Collins, 1988). Was it growth of the narrow, central bank monetary base (M1) or the broader money supply, that counted all bank liabilities as part of the monetary stock (£M3). Ultimately, despite the preference of the monetarist ideologues, £M3 was chosen. There were many competing claims over its efficacy, but £M3 had a potency other measures lacked: It was controllable. As David Cobham, one of Britain’s leading monetarists wrote “the authorities had to believe that they had a technique for controlling the money supply as defined in this way (by acting on the various credit counterparts)” (Cobham, 2003, p. 28). Though control of the monetary base was considered, and stimulated the most discussion in responses to the Monetary Control Green Paper, both the monetary authorities and the wider financial sector, accepted that in an

environment where wholesale money was more dominant, controlling the monetary base was not especially relevant.<sup>22</sup>

Perhaps more significantly, the most influential macroeconomic model - that developed by Alan Budd and Terrance Burns at the London Business School - had a working 'proof' of a stable link between £M3 and the PSBR (Kenway, 1994). As such £M3 could be controlled by manipulating the PSBR with the model showing the precise adjustments needed to public spending and the sale of gilts (which acted to reduce £M3) needed to hit the desired targets on monetary control. That made it the obvious aggregate to pursue, despite the fact that many of the 'pure', economic monetarists - including the vocal theorists closest to Thatcher's administration like Milton Friedman, Alan Walters, Patrick Minford and David Cobham, and indeed the Treasury itself - all preferred monetary base control (Needham, 2014a). Interestingly the Bank of England, which was sceptical about monetary targeting in general after the CCC fiasco, much preferred £M3 because it would entrench the position of interest rates as the main driver of policymaking (Goodhart, 2014b). And this was something that the Bank retained influence over. As an aside it is worth recalling how fiscal policy made the Treasury the most important public authority in the pursuit of economic governance. The transformation towards interest rate control greatly empowered the position of the Bank of England, something that has continued up to today. Nonetheless, the debate over the chosen aggregate to be controlled is important insofar as it demonstrates again the dangers of assessing the significance of Thatcherism, monetarism and deregulation in terms of the rhetoric and ideologies of the time. There is always a disjuncture between these grand terms and the more prosaic matter of making a policy enactable. Which is why my interest in the Monetary Control Act lays in the links it forged between the Bank Rate and the wholesale money rate.

The Act did not come from nowhere. I would argue that it is better thought of as the culmination of a series of changes stemming from the state's effort to establish interest-rate control of broad liquidity in the economy. Most important in this regard is the MLR policy that emerged a year after the chaos unleashed by CCC. This was the first move away from using the discount window to set the Bank

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<sup>22</sup> In Treasury consultations released through a Freedom of Information Act it was made clear that monetary base control was thought to be "a redundant step" (in Bridgeman, 1980, p. 14).

Rate (Burnham, 2011). Instead rates were set in reference to the prices established in the weekly Treasury Bill tenders. To recall the discount window set a ceiling on the price of liquidity but not a floor. In order to 'make the Bank Rate effective' (on the discount window) the Bank of England had always had to try and manufacture a liquidity shortage in the clearing banks. This it did by issuing Treasury Bills to discount houses, who were compelled to buy them, draining the discount houses of available cash, which in turn fed back to the clearing banks. The result of which was that liquidity could only be borrowed from the Bank of England via the discount houses on the discount window, at a decreed interest rate: the Bank Rate (Allen, 2014). In that sense there was nothing new about the Bank of England's interventionist dealings in Treasury Bills. What did change with the MLR was where rates were set. In its Treasury Bill dealings, if the Bank chose only to buy back Treasury Bills at low prices, it was able to force short-term interest rates up, independently of the 'discounting' price for liquidity set by the Bank Rate (*ibid.*).

When in October 1972 the MLR policy was announced it involved using this capacity more actively. The Bank Rate was going to be tied much closer to the rates that prevailed in the previous week's Treasury Bill tender, though adding 0.5 per cent and rounding up to the nearest 25 basis points (Needham, 2014a, p. 59). The hope was that this would allow for more frequent changes and dampen the 'announcement effect' that happened when changes were made to the (discount window) set Bank Rate (*ibid.*). The move to MLR has often been described as the first move in the postwar effort to depoliticise monetary policy (Burnham, 2011), and certainly in the effort to disarm the effects of 'announcement', and the discussion of letting 'markets' set rates, it is easy to misconstrue the MLR in this way. But for all the reasons I argued in the previous chapter, and the fact that the policy was about trying to harness state control of liquidity, it is the wrong way to read the shift. Instead, MLR is better thought of as a crucial building block in the transformation of liquidity governance that was implemented more fully by Thatcher's government in the Monetary Control Act of 1980.

The Act followed another significant regulatory change, the relaxing of controls on the international movement of capital in retail banking that Thatcher introduced shortly after taking power in 1979 (Bank of England, 1982). The result of which was to allow banks to raise money overseas, and companies and individuals to borrow and save overseas without additional government charges. In an instant this brought to a close the relevance of the Supplementary Special Deposits

scheme (commonly known as 'the corset') that had for the previous six years acted as a control on bank asset growth (Moran, 1983). Introduced in December 1973 in the midst of the CCC fiasco it compelled clearing banks to deposit a proportion of their non interest-bearing cash with the Bank of England and in doing so inhibited growth of banks' interest-bearing liabilities, in an effort to stem the supply of clearing banks' loanable funds, and tackle the problem of round tripping (HMT, 1980, p. 5). The existence of the corset spoke to the problems presented by the credit revolution that had undermined the capacity of central bank interest rates to control general financial activity. The corset rule, however, by forcing clearers to keep some cash at the Bank of England, restricted their ability to bid for funds, limiting the growth of their balance sheets, and curtailing lending (Reid, 2003, p. 52). Yet, as the monetary authorities were well aware, this only encouraged customers to look beyond the clearing banks. As such the corset encouraged disintermediation. And once capital controls were lifted, the corset made little sense because customers could easily borrow from foreign banks anyway. In that sense, ending corset control was as much about reviving the influence of the Bank of England's as it was about freeing financial markets. Yet even if the corset was removed, there remained the issue of how to make the Bank Rate effective in a world where wholesale finance was more important than public debt for meeting liquidity positions.

The Green Paper on monetary control (HMT, 1980) outlined that interest rates would no longer be managed through the discount window, but instead would take place through open market operations. Under the new system, which was implemented in August 1981, it was said that the monetary authorities would 'let markets dictate interest rates'. A more revealing description would be that the Bank would bring money market rates and the Bank Rate into closer proximity. As the Bank of England (1980, p. 428) wrote its "operations would be broadly intended to offset daily cash flows between the Bank and the money markets". The new system worked like this: At the beginning of the week the clearing banks would submit an estimation of their cash needs for the following week. If there was an expected cash shortage, the Bank would buy Treasury bills outright, flooding clearers with liquidity. If the clearers expect there to be a surplus, however, the Bank would buy bills on the expectation of selling them back when the surplus arrives. The Bank did this within a general target for very short-term interest rates, refusing to buy bills at certain prices, in a similar manner to the MLR policy. But no longer would the Bank

try to manufacture a shortage of liquidity by over-issuing Treasury Bills at the weekly tender (Wood, 1983, p. 111).

These interest rate targets weren't published, heightening the impression that they were set more by 'market interaction' than discretion by the Bank (Burnham, 2011). As part of this shift, and in recognition of the declining relevance of central bank liquidity, there was a move away from reserve ratio control towards a more general emphasis on capital adequacy (Gardener, 1983). As such under the new system the 12.5 per cent reserve asset requirement was dropped, and the rule where the clearing banks had to maintain a 1.5 per cent cash balance at the Bank was also discarded (Collins, 1988, p. 508). The move away from reserve requirements came from a recognition, again, that central bank liquidity mattered less in an era of liability management and wholesale finance (Bridgeman, 1980b). In part this was a consequence of the interlinking loans the parallel money market had developed, which meant developing "prudential tests" that "look at the liquidity of the system as a whole, as well as the liquidity of an individual institution which might be relying substantially on assets at other banks" (Bridgeman, 1980b, p. 7).

The only direct requirement established through the Monetary Control Act was the necessity of all deposit taking financial houses, including but no longer limited to the clearers, to hold a small proportion of cash reserves (0.5 per cent) with the Bank of England (which it used for its daily operations). In order to make the new system of open market operations function, banks also had submit to the Bank of England statistics on retail deposits (M2) (Cuthbertson, 1984, p. 58). The hope was that in acquiring this data the Bank would be better placed to make the crucial calculation of the broad monetary stock, the total liabilities of the banking system (£M3) which was the monetary target around which Thatcher organised the MTFS. In that sense though the Thatcher administration was keen to emphasise a 'deregulating' ideal guiding the changes, it is clear that central control was still being enhanced. Certainly the Bank was very clear that once the corset had ended, interest rates were the only (imperfect) means through which to act out monetary policy (Goodhart, 1989).

The move from the MLR to open market operations was important in two ways in particular. Firstly, the unpublicised targets solved, for a while, the problem the authorities faced by the ever growing politicisation of interest rates and allowed for more frequent short-term changes to be carried out. Second, and maybe even

more significantly, it also helped the base rate to move more quickly in line with the rates banks accessed wholesale money (Cuthbertson, 1984, p. 59).

Throughout this period of financial reform, and indeed through the decade that had preceded it, monetary policy had been articulated in terms of the need to 'keep prices steady', and bring about a permanent reduction in inflation (Gamble, 1994). It is for this reason that 'monetary discipline' is so often associated with Thatcher's financial reforms. On the basis of a (as it turned out unfounded) assumption that inflation came from growth in the monetary stock, targets were established for £M3 to which interest rates were supposed to adjust. Notionally the idea was that this would help guard against 'expectations' of future price rises (Keegan, 1984). This, in turn, could provide a link between the target-driven Bank Rate and the longer-term rates on the gilt market. One of the major problems, identified by the Monetary Control Green Paper (1980), was that the newly speculative gilt market had combined with monetary control targets to deepen volatility. This is because if £M3 grows faster than the target range, gilt investors would expect future interest rates to rise and would, as a result, hold back from buying gilts, because they would wait for the better terms they predicted were soon to be offered. This would force greater Treasury Bill issues (to finance the national debt) and accelerate the growth of the money supply (£M3) and increase liquidity. As such, a stop-start irregularity developed in the gilt market.

Nonetheless, the authorities hoped the new era, where frequent adjustments to the Bank Rate through open market operations would rapidly adjust rates across the board in line with targets on monetary growth, would "strengthen confidence in effective monetary control, and so could encourage greater long-term stability in the gilt-edged market" (HMT, 1980, p. 13). Underlying this is the belief that long-term interest rates could be brought down - or at least demand for long-term government borrowing stabilised - through monetary discipline because investors would no longer have to worry about their holdings being 'inflated' away. Yet the question remained over how short-term rates, which the Bank tried to shape through its actions with Treasury Bills, and long-term yields on the gilt market, really related. Certainly the aspiration to target £M3 - even if that aspiration was routinely unfulfilled - meant trying to move away from funding the debt through the Treasury Bills and relying more on the gilt market (Goodhart, 1989). At the same time, this new emphasis on constantly varying short-term interest rates made the gilt market less stable. There was, as I discussed in the previous chapter, widespread



recognition that the operation of the gilt market needed to reform to make the market for gilts bigger and more liquid. This was achieved through the second regulatory change that this chapter examines, the Big Bang reforms of 1986.

### 6.3 The ‘Big Bang’: Remaking the gilt market

The financial reforms of the 1980s are often discussed in terms of how they helped to establish monetary discipline and further the interests of Britain’s financial sector. Yet narrowing the view and instead considering how the reforms affected the state’s capacity to manage liquidity, shifts our understanding of their impacts and their importance. It becomes possible to argue that moving to a system that set the Bank Rate through open market operations on the bill market helped the Bank of England adjust interest rates more quickly to developments on the wholesale money markets. Nonetheless there remained the second problem with the operation of public debt management. Namely the incapacity of the gilt market to cope in the new era of monetary targeting.

#### Gilt troubles

By 1980 Britain’s outstanding gross debt was £95.3 billion (Nield, 2012). It had been four years since the country was forced to seek IMF help and the economy was suffering under the strain of Thatcher’s failed attempt to bring money creation under control. The operation of the gilt market had been under intense pressure since the CCC changes that withdrew Bank of England support for the gilt market and made gilt investors especially attuned to the behaviour of government policy (Thomas, 1986). At a time when finance had been profoundly changed by the presence of American financial conglomerates and their use of liability management as part of the credit revolution, the operation of the gilt market seemed caught in another age.

This mattered. As the Wilson committee (1980) reported just after Thatcher took power, the traditional gilt market was no longer fit for purpose. Selling gilts was a delicate operation which had also been transformed by the changing landscape of investors. Since the 1950s, institutional investors had grown in size and with traditionally long-term portfolios they were a key participant in the gilt market. By 1979 pension and life assurance funds held £4.6 billion of long-dated (15-years or more) gilts, what amounted to 65 per cent of the entire market (Wilson Committee,

1980, p. 181). The volatility in the market that, as I have discussed, emerged with the move towards interest-rate based governance of the macroeconomy meant the authorities were searching for solutions. Though they had confidence that the market structure could ensure new issues would be sold when general conditions were favourable, they were far less sanguine about the prospects for gilt sales in conditions of uncertainty and at times of inflation. The early 1980s especially, was such a time, and, as the Wilson report lays out, the authorities were unsure investors would subscribe to new gilt issues and in that sense were fearful of a looming crisis in government financing. This was all the more pressing because Thatcher had committed to tax cuts for high income earners and was overseeing a recession that forced higher social security spending. Described in the Wilson report was the view of the monetary authorities that the instability on the gilt market could be resolved with a system that was able to undertake large issues (Wilson Committee, 1980, p. 182). This, as I discussed in the previous chapter, was however limited by the relatively small size and tiny capitalisation of the jobber firms that arranged gilt sales on the London Stock Exchange. It is worth remembering that this presented a problem for hopes of monetary control because the gilts that went unsold were taken onto the Bank's balance sheet (through the Issue Department) in exchange for Treasury Bills. This left the Bank's overall asset size unchanged (Goodhart, 2012, p. 124) but swelled the number of Treasury Bills in the financial system, driving credit creation at precisely the time Thatcher's regime had committed to bringing it down. The authorities were, once again, in a bind of trying to meet seemingly contradictory objectives. At once they wanted to control the money supply, borrow more, and maintain liquidity in the gilt market. This was the situation the monetary authorities confronted in 1980s, and the solution that was really needed was a fundamental overhaul of the mechanism through which gilts were sold. It was thought that moving to a tendering system for gilt sales, could resolve some of the tensions. As Tony Coleby, who was head of the gilt-edged division at the Bank of England, outlined:

“The most coherent alternative to our existing way of operating was to move to a system based on the auction technique, but that would not have provided a quick fix because it needed to be set up as a comprehensive programme” (in LSR, 2006, p. 8).

Under the existing arrangement gilts were issued on both the primary and secondary market at prices set by the Bank, with investors dictating yields. Under a

possible tender system, the Bank would announce its intention to issue a certain volume of securities to be taken up on a particular date (or over a given period), and investors would determine both the price and yield at which they were prepared to buy them (Wilson Committee, 1980). Indeed, the idea was not new to Britain. The Bank had introduced a form of partial tender in 1979 where new gilt issues were announced with a minimum tender price that was set in line with market yields. One of the boons of the 1979 change was that it secured the monetary authorities any gain from a potential improvement in investor sentiment that occurred between the announcement of the issue (and its terms) and the date for its subscription (*ibid.*). While useful this was not sufficient (and nor was its intention) to smooth the path of sales in the new era of volatility, and whenever investors proved unwilling, the Bank would be in the same position of having to absorb the unsold issues and open the 'tap' of Treasury Bills in the usual way. Put simply, the authorities could not at once stipulate a minimum price, while at the same time hope to guarantee the sale of a set amount of gilts. There was always the problem that, even if they could, investors would only enter a tender at prices so low, and yields so high, that the cost of government financing would be too big to bear. As such the promise of a reformed system was to guard against this danger by having tenders be underwritten at near market prices. This would allow the Bank much larger issues, for example six months' worth of gilts at a time, with clear announcements, and would ensure no alarms and no surprises. This would ensure smooth sales, in the sense that a price would always be found to sell all the gilts (*ibid.*). This would be better suited to the new post CCC environment where investor action in the gilt market was based more closely on an assessment of what government policy would imply for future rate changes.

The monetary authorities clearly favoured change. Alongside Coleby, quoted earlier, and the Wilson report mentioned above, chancellor Nigel Lawson wrote to Thatcher in October 1980: "We need to discuss not only short-term interest rates and the banking system, but also methods of funding and the possibilities of smoothing the path of public sector borrowing" (7A-174-6 f.179, Margaret Thatcher Foundation Archive).

While there was, in that sense, consensus about the need to overhaul the market and move towards an auction system, there were doubts over the capacity of the existing market to handle such a change. To recall, the gilt market was dominated by two jobber firms that accounted for nearly 80 per cent of its sales

(Kerr, 1986), and neither was well capitalised enough to take on the large issues needed to make a tender system work in the way the authorities desired. “My judgment,” said Coleby (in LSR, 2006, p. 7), “which was widely shared in the Bank, was that we did not have a compatible structure... the [feature being] an absence of a body of strong, well-capitalised, market-making intermediaries who were the core players in an... auction method.”

The problem facing the gilt market was two fold. Firstly, the monetary authorities could never be sure that gilt tenders would be fully subscribed, which meant it continually had to take on issues itself and open the taps for Treasury Bills. Second, and related, the solution to the above problem - a tender system - was curtailed by the fact that the apparatus through which gilts were sold on the Exchange was limited because of the dominance of small, lightly-capitalised British financial houses.

Neither of these issues could be articulated in the brute terms of the necessity of monetary discipline or the imperatives of creditors. Both, however, threw up a significant issue in the operation of monetary policy. In examining the monetary infrastructure through which governance takes place, the Big Bang reforms, as I will show, take on a different significance. It was not monetary discipline nor the promotion of the financial sector that drove the reforms, but rather was the dilemmas of the gilt market. To even try to enact monetary policy in the way it wanted, the state needed to open up new avenues of debt management.

### The roots of deregulation

Bound up with the idea of Thatcher’s imposition of monetary discipline is that it promoted creditor interests and those of the financial sector more broadly. This colours how financial regulatory reform is understood, in particular with the Big Bang which is often depicted as an iconic example of Thatcher’s deregulatory zeal (for example Rogers, 2014). Yet the desire to reform the London Stock Exchange - on which gilts were sold - actually emerged in the second half of the 1970s, when the Labour party was in power (Vogel, 1996). Though the economy at large was suffering in the 1970s - and would ultimately lead to the Labour party’s expulsion from government - the City itself was booming (Plender, 1986). The fact the City could prosper seemingly independently of the rest of the nation was something that frustrated Labour MPs and, as such, when the City was beset by a raft of insider trading scandals, the Labour government was keen to force through reform (Kerr,

1986). This meant that at just the time when the Bank was first trying to find ways to better manage the tensions on the gilt market, the Labour government instigated an OFT case against the London Stock Exchange (Kandiah, 1999). The body's officers had visited regulators in America and Canada and found they were able to draw on an electronic audit trail that could never have happened under the structure of London's Exchange (*ibid.*).

When Thatcher defeated Labour in the 1979 election the pressure on her newly-formed government to do something about the City was heightened by the Wilson report's call for change to the organisation of the Exchange. Importantly for Thatcher, however, the report also insisted that OFT action was not the best solution to the City's problems, and the Conservative government was only too happy to oblige and drop the case (Moran, 1990). Instead, Thatcher and her trade and industry secretary Cecil Parkinson, bargained for a promise to open up the Exchange and this created the space to overhaul the market in the way any move to a tender system would require. As such in July 1983 it was announced in the House of Commons that the jobber-broker split would not continue, and in April 1984 the full details of the changes to be made to the Stock Exchange were announced in its Discussion Paper (1984).

"The Stock Exchange has... clear objectives in designing and developing a new market structure," wrote the Discussion Paper (1984, p. 8). "The system of dealing must aim for the best possible level of liquidity or depth of market and wherever possible to provide continuous two-way trading." To achieve this there were four commitments laid out: first, a deeply capitalised market system to ensure liquidity; second, admission of outside houses; third, a system that served large and small investors - wholesale and retail; fourth, the gilt market remaining an integral part of the Exchange.

Given the monetary authorities' frustration with the lack of capitalisation of British houses, and the plan to open up the Exchange to foreign firms, it was clear to people organising the reforms that there would follow a great period of instability. At the time Lawson correctly foresaw that "[t]here would be strong pressures on British-owned businesses from American and Japanese competition" (in Pickard and Thompson, 2014). Once the Discussion Paper set out the changes and date for the Big Bang there was a flurry of merger and acquisition activity as financial houses tried to prepare for the inevitable onslaught that Lawson was eluding to. Banks that had previously had very little experience of both sides of securities

dealing (jobbing and brokering) joined together, with brokers especially gaining enormously. In the buyout boom that occurred between the announcement in 1984, and the implementation of the changes in 1986, 750 millionaires were created as old, partnership firms were paid off in deals where selling prices vastly outstretched the real worth of the firms' equity (Augar, 2000, p. 81). This story of mass buyouts and the introduction of American 'culture' to the London dealing rooms - alongside the new electronic trading screens - dominates memory of the reform. But often overlooked is the extent to which the gilt market after the Big Bang barely resembled what had gone before.

By viewing this transformation of the gilt market in terms of the desire to resolve the tension between government debt management and its effort at monetary control, it is possible to move towards an understanding of the reforms that do not resort to standard critical accounts based on the abstract template of 'monetary discipline' or 'market-rule' and the promotion of the financial sector.

#### After the Big Bang

The history above should challenge the way in which we understand the significance of Thatcher's 'monetary discipline'. The very idea that Thatcher restored monetary discipline is founded on the principle that excessive public debt is unsustainable and that it demands a resolution which inhibits the state's room for manoeuvre and empowers creditors and the financial sector. It is on this basis that Thatcher's legacy as a pro-finance prime minister is founded. Yet when the reforms are examined from a perspective that sees public debt securities as crucial to the infrastructure of governance, the reforms take on a different light. It becomes clear that it is insufficient to assert that the reforms were about the state 'establishing the City as a financial centre' or 'forcing capital to be free' in the pursuit of monetary discipline. Rather, the state's own interest becomes clear. The state, as a debtor, needed to find ways to better manage the national debt so as to make possible an alternative monetary policy, and the Exchange was a key site where it could exercise its agency.

As I now outline, by remaking the rules of the Exchange, the Big Bang substantially changed the gilt market's operations, widening the market for long-term British public debt, and deepening its liquidity. In that way the reforms empowered the British state. Previously, two jobbers dominated nearly 80 per cent of the market. After the reforms there were 27 (Bank of England, 2013). Whereas

previously British companies ruled, now American banks joined too. The effect was to deepen capitalisation in the market and widen the network of possible buyers of gilts (Bank of England, 1984), which together extended their marketability beyond recognition.

One crucial change was replacing the single-capacity system with new integrated financial houses. Previously, the brokering role for gilts was separated from the jobbing role with different firms managing each. The Big Bang worked to unite these two aspects into newly formed Gilt Edged Market Makers (GEMMs). These are firms that purchase gilts directly from the Bank and sell them directly onto their own clients. In this way the trading and sales of gilts worked in a single operation (Bank of England, 1989). For the newly registered GEMMs - which now included the likes of Goldman Sachs, JP Morgan and Salomon Brothers - this meant the Bank would originate and tender a variety of different gilts and the GEMMs would fix their price by buying them at a certain rate of their choosing before selling them on (*ibid.*). The direct access these GEMMs had to the Bank meant that after two hundred years there was no longer intermediation provided through the Government Broker.

Moreover, now the whole set of GEMMs were granted the technical and fiscal privileges enjoyed only by a very limited number of gilt-edged jobbers previously (Thomas, 1986, p. 72). Before the reforms the two big gilt jobbers had the unspoken privilege of borrowing from the Bank. In the restructured gilt market this lending facility was codified and made available to all 27 GEMMs. These GEMMs, as I mentioned, were not narrow banks specialising in gilt trading either. They were high street names and international investment houses (Bank of England 1989). It meant that a large group of big financial houses had direct backing from the Bank. This was money that could be borrowed on a secured basis, and was available at the initiative of the GEMMs themselves when their routine sources of financing were not available. Though of course they rarely needed it, the implicit promise of support meant that the GEMMs were able to raise cash from other sources on better terms (Thomas 1986, p. 76). It is precisely why when the plans for the reforms were announced and the Bank sent out a call for applications to become GEMMs over 50 firms initially expressed an interest. Though in the end 27 were taken on, they all agreed that they would be prepared to take on larger amounts of gilts than ever before. As the Bank of England (1989, p. 49) wrote three years later, when evaluating the 'gilt-edged market since the Big

Bang', "the new structure [was] successful in providing a continual and liquid market for investors and official operations."

The result was a massive increase in capitalisation in the market. Whereas previously the capital of the gilt-edged jobbers was estimated at around £100 million, the capital of the 27 GEMMs amounted to £595 million, and by 1989 stood at £610 million (Bank of England 1989, p. 51). This large capital base is what allowed the GEMMs to absorb much larger issues of gilts, and their international client base meant finding customers proved not to be a problem. Even on other measures of liquidity the new market structure proved more sophisticated. Turnover of gilts increased from around £1 billion a day before the Big Bang to around £4 billion a day by 1989 (*ibid.*). This was in large part because the bigger pool of GEMMs traded with each other but there was also a big increase in customer turnover. Investors, of course, gained through the end of fixed commissions, with a reduction in wholesale costs of almost 60 per cent (*ibid.*). These lower costs for investors meant they were more willing to take on gilts at lower margins, cutting spreads in half, this despite the number of deals increasing (*ibid.*).

This may sound like arcane intricacies when set against grand theoretical debates about the 'debt state' but in such detail theoretical clarity lies. The great expansion in liquidity of government securities and the great swell in the size of the gilt market meant that the monetary authorities were able to construct policy differently. As I outlined in the previous chapter, managing liquidity through variations in interest rate was ineffective previously, because debt financing through Treasury Bills only served to increase the broad money supply. After the reforms, if the Bank wanted to reduce liquidity in the financial system, it was able to sell gilts on a much greater scale to non-banks, and in this way "exert some control on broad money growth by absorbing from the non-bank private sector liquidity created by bank credit" (Allen, 2012a, p. 25). The problem of having to 'lean into the wind' and manage the pace of gilt sales - which was impossible in the old system where brokers and jobbers could not underwrite government auction of gilts - was resolved by the new dealing mechanism that Bank of England insiders had longed for in the 1970s.

It is well established that public debt is the life blood of government. Yet too often the state's indebtedness is depicted as its key weakness. This is because by occluding the monetary aspects of public debt, and the monetary infrastructure that is created through it, means critical literature on debt is often anchored on the idea



that the growth of public debt is unsustainable. As such critical accounts unfold from the perspective of creditors and their presumed interests to whom the state is supposedly dependent. From here it is very difficult to see how the state can use the monetary infrastructure to empower itself. This is very clear in the case of the 1980s financial reforms. These, on the face of it, look a typical neoliberal pro-market restructuring of the City of London, but they actually had key implications for public finance and empowered the state by broadening the market for public debt.

## Conclusion

The operation of public finance in Britain is deeply intertwined with the governance of the broader economy as a whole. For that reason, examination of how the state raises debt and manages liquidity provides a crucial vantage point from which to reconsider the importance of Thatcherite monetary reform. Doing so allowed me to show the precise interest the state had in the reforms, and in that way capture the agency of the state that is easily lost in the notion of 'monetary discipline' that is usually ascribed to Thatcher.

Through revisiting two key reforms, the Monetary Control Act of 1980 and the Financial Services Act of 1986 - the 'Big Bang' - I showed how financial reform can be better understood in terms of the state's struggle to build the capacity for debt governance. The Monetary Control Act transformed the way the Bank Rate was set, allowing rates to adjust more rapidly to developments on wholesale markets, while the Big Bang reformed the London Stock Exchange and its biggest component, the market for long-term government debt. As such the size and liquidity of the gilt market expanded greatly, resolving the problems that had built up in the gilt market since the CCC experiment.

In doing so I outlined how the state, through the postwar years, continued to find ways to use public debt securities as a basis for its power. Though public debt is nearly always presented as a grave problem and threat to the state and the sovereignty of government the chapter and those that preceded it demonstrated how the moneyiness of debt muddies the creditor imperative and means constantly growing debt does not necessarily spell disaster for a government. Instead the British monetary authorities have long used monetised public debt for their own ends, so deeply institutionalising the process that the threat of unsustainability has almost been muted altogether. In that sense by acknowledging its monetary aspect, 'the problem of debt' is transformed. Sophisticated governance of the liquidity of

public debt has allowed the British state to amass vast public debts, whose final repayment has been delayed indefinitely (Sgambati, 2016). The public debt originated when the Bank of England was first formed sat on its balance sheets for three hundred years, and the £1 trillion national debt the British state has currently amassed is only set to grow (Keep, 2016). This should force us to reconsider how we examine debt politics.

# Conclusion

The capacity of the state to issue its debt as money in England underpinned its great rise as an economic power and established a unique trajectory to its political economic development. From this ground - one that recognises the moneyiness of debt - this thesis has cast the politics of public finance, and the politics of the British 'debt state' in particular, into a new light. This is because the challenge of managing public finance is transformed by the monetary aspects of debt. The issue becomes less about the steps the state must take to attract investor interest and more about governing the monetary infrastructure through which the state relates to the broader economy. This insight provided the platform for this thesis to break out of the paradigm of creditor dominance and in doing so provided a deeper understanding of the emergence of neoliberal financial governance in postwar Britain and the role of the state in its construction.

The central claim of the thesis is that the British state has never been a passive recipient of the agenda of creditors when it has raised public debt. Precisely because of its monetary dimensions, raising public debt has been very productive for the power of the state. It made financing easy to access and more importantly established a monetary infrastructure through which the broader economy could be manipulated. For this reason, the massive public debt racked up by the British state at no point resulted in it becoming a mere instrument of the power of creditors. In making that claim I established an alternative understanding of the emergence of neoliberal financial governance in Britain. The reforms to the financial sector that took place through the 1970s and 1980s are often taken to be both a cause and a symptom of the declining power of the state to forge its own monetary history. Neoliberalism, in that sense, is often depicted as the consequence of the growing ability of creditors acting on financial markets to discipline a subordinated debtor state, bending government policies to their will. Yet through this thesis I have instead shown how central the British state's own interests were to shaping the way it constructed neoliberal financial reforms.

In doing so this thesis made a methodological, conceptual and historical contribution. Methodologically, I constructed a historical framework of inquiry capable of capturing the moneyiness of debt. This meant examining how public debt acquired the ability to serve as money and how this established an infrastructure

through which the state was able to use public debt to govern the economy. It was this framework that allowed for the conceptual contribution, establishing an alternative reading of the relationship between public debt and neoliberalism. I showed how public debt is not necessarily constraining, but instead worked to empower the British state. As a result, rather than pin neoliberal financial governance to the interests of creditors and the power they wield through financial markets, I showed how central the interest and role of the state remains.

When instead the question of public debt is recast in full recognition of its monetary aspect, the political implications are transformed. The state does not have to constantly struggle for ways to appear attractive to investors, and as such the historical trajectory of the institutions of monetary governance is much more contingent. This makes it possible to grasp how the British state has long had the capacity to continually amass public debt, well beyond the levels where any prospect of repayment is feasible. I showed, in that sense, how the examination of public debt cannot depart from the problem of solvency, but instead must explore how the state tries to govern the liquidity of its debt.

To make this argument meant tracing how the difficulty of coming to terms with the Financial Revolution, and the way it provided the English state an ability to issue its debt as money, led the literature on debt and public finance to occlude the monetary dimensions of public debt. As such, accounts about the historical development of monetary governance in Britain are often anchored by an assumption that growing public debt is unsustainable and presents a problem that the state is constantly striving to overcome. The result is that the historical development of institutions of public finance are depicted as driven by the need to solve the 'credibility' problem, an issue that is posed from the perspective of creditors, making it very difficult to account for the state's own interest.

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From this basis I made a historical contribution through the thesis, demonstrating how the British monetary authorities developed the means to grow and service public debt and the way in which public debt securities were used to govern the economy. In the second chapter, I outlined how the Financial Revolution

set British public finance on a unique trajectory. I traced how public debt acquired monetary features and showed the way its gradual institutionalisation into the political economy over the eighteenth and nineteenth centuries laid the foundations for the Keynesian revolution in economic governance after the second world war. I demonstrated in the third chapter how Keynesianism marked a shift in the understanding of the state's relationship to debt. Recognition of its moneyiness allowed the state to treat debt as a tool of economic governance, rather than a problem to be avoided. In that sense Keynes can be thought of as helping to found a monetary revolution in policymaking, rather than just the fiscal policies with which he is often associated. For that reason, I argued that the Keynesian revolution marked a major shift in the paradigm of public finance. After the second world war it had been accepted that public debt could indeed continue to grow, and pay for itself, provided it was used to harness productive investment. The levels of public debt grew greatly after the war but coincided with a growing economy.

This Keynesian regime of governance was, however, undermined by innovations in private sector finance. American banks, who first came to operate on London's Euromarkets in the late 1950s, brought with them an emerging practice of liability management which, as it developed through the 1960s and early 1970s in Britain, helped private banks treat their own debts as money. The result was a dramatic expansion in the levels of credit through the early 1970s, something that undermined the mechanics of liquidity control that the British monetary authorities had established. As a result, the monetary aspects of debt had now become a problem for the state. The fiscal boundary was recast as a monetary limit.

The 1970s shift in the political economy of finance has often been expressed in terms of a deregulation of finance, or a move to market-based governance. Yet by revisiting the credit revolution in the fourth chapter I provided a way of grounding the shift in terms of a particular financial practice, that of liability management. The advantage of doing so is that it helps connect the great expansion in finance to the monetary infrastructure that was already in place, showing how the credit revolution took place by using the institutions of Keynesian governance rather than destroying them. Nonetheless, the credit revolution did demand a response. To govern successfully the state needed to transform its capacity to guide liquidity when much credit was being created outside of its operations of public debt.

In the final two chapters I looked at the state's role in the construction of neoliberal financial governance. I demonstrated how growing public debt did not bring about a depoliticisation of monetary governance and an erosion of the discretionary power of the state, but rather a reconciliation with the tensions that had built up over the previous decades. The financial reforms of the 1970s and 1980s worked to greatly expand the size and liquidity of the market for its own debt. In that sense, the mode of governance was transformed with the state enhancing its capacity to govern the broad economy through indirect management of liquidity. None of this was planned before hand and simply put into practice, either by the state or by the creditors who financed its growing debts. Rather this was a capacity that emerged out of the monetary authorities' often failed attempts to address specific problems they were confronting.

The capacity the state developed to manage the rhythms of liquidity creation only grew after the 1980s. As private credit exploded over the years of the Great Moderation and the parallel banking sector - or shadow banking as it was to become – grew ever more important to the global political economy, the position of public debt securities evolved once again. There is an emerging literature examining the way in which public debt has established itself as the final backstop of liquidity (for example Gabor and Vestergaard, 2016). This is because in a highly leveraged financial system, where sophisticated securitisation on both the asset and liability side of bank balance sheets has made risk very difficult to manage, public debt securities - particularly US Treasury Bills and UK gilts - are crucial. This has allowed both countries to pile on the debt despite running significant budget and trade deficits, at the same time as achieving anaemic levels of economic growth. This is all the more extraordinary in Britain given the scarce relevance of sterling as an international currency for trade. Such is the strength of the investor demand for UK public debt that the state has been able to shape the market with the QE policy that sees the Bank of England print its own money to buy its own debt issues, lowering both the cost of public debt and interest rates more broadly, while helping to inflate the assets on which further private borrowing is secured. Moreover, the money it has created has allowed the Bank of England's Asset Purchasing Facility to amass a huge volume of assets for itself on which it is now making a profit (Bank of England 2016).

Monetary governance has been the British state's primary response to repeated financial crises and the concurrent stagnation of economic growth over

the last two decades. Whatever the attention given to growing public deficits in recent years, the level of public debt continues to rise. This irrevocable relationship the state has with the market economy is pivotal to the dynamics of contemporary neoliberalism. This is apparent in the connection between monetary policy and the system of debt-based growth that defines Britain's political economy. The call by some critical voices that a reshaped QE could be mobilised to redistribute wealth and promote a more progressive British political economy is a timely recognition of both how deeply embedded monetary relations are in the everyday functioning of Britain's economy, and the possible opportunities this provides. To realise these opportunities will require broader progressive politics to shift out of its habitual focus on fiscal policy. The infrastructure by which debt comes to serve as money and the political economic implications this holds for the state in particular must be examined more concretely.

One of the fundamental problems with contemporary analysis of the politics of finance is the way creditors are depicted as all-powering masters of the universe. This presents a major hurdle to progressive politics. By recasting the neoliberal turn in monetary governance in a way that captured how the state has been empowered through its use of public debt, this thesis provided a new perspective on the politics of public finance. States are not at the mercy of faceless creditors: there is an infrastructure in place that can and must be turned to progressive use.

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